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Supreme Court, U.S.
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No. 07-

IN THE

Supreme Court of the United States

BILLY D. DOBBS JR.,

Petitioner,

v.

RICHARD MEHRLICH,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

JOSEPH J. HASPEL
THE LAW OFFICES OF
DAVID CARLEBACH
40 Exchange Place
New York, New York 10005
(212) 785-3041

Attorneys for Petitioner

212487

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

QUESTION PRESENTED

The Bankruptcy Court granted the Respondent's motion for summary judgment in the bankruptcy proceeding and declared the Respondent's debt against the Petitioner non-dischargeable based on the finding of fraud in a prior arbitration proceeding. The Bankruptcy Court's decision was affirmed by the District Court and the Court of Appeals for the Second Circuit. The question presented is:

Whether the Second Circuit erred by holding, in conflict with the Court's and the Eighth and Fifth Circuit's prior decisions, as well as the Second Circuit's own precedent, that an arbitrator's finding of fraud based on a standard different than the standard for fraud under Section 523(a)(2)(A) of the Bankruptcy Code can be given collateral estoppel effect to deem a debt non-dischargeable under Section 523(a)(2)(A).

TABLE OF CONTENTS

	Page
Questions Presented	i
Table of Contents	ii
Table of Appendices	iv
Table of Cited Authorities	v
Opinions Below	1
Jurisdiction	1
Statutory Provision Involved	1
Statement of the Case	2
Background	3
Reasons for Granting the Petition	7
I. The Second Circuit's Decision Conflicts With The Court's Decision In *Brown* Which Established That, Contrary To The Second Circuit's Notion, A Bankruptcy Court Cannot Utilize "Factual" Collateral Estoppel When The Underlying Finding Of Fraud Was Based On A Legal Standard Different Than That Needed For Fraud Under Section 523(a)(2)(A).	7

Contents

Page

II. There Is A Square And Explicit Circuit Conflict On The Important Issue Of When The Bankruptcy Court May Give Prior Determination Of Fraud Collateral Estoppel Effect In Relation To Section 523(a)(2)(A). 10

III. The Second Circuit's Decision In *Ball v. A.O. Smith Corp.* Supports The Petitioner's Argument That An Identity Of Standards Is Required For "Factual" Collateral Estoppel Under Section 523 Of The Bankruptcy Code, And, Thus, The Decision In This Case Conflicts With The Second Circuit's Own Precedent. 14

Conclusion 16

TABLE OF APPENDICES

Page

Appendix A — Summary Order Of The United States Court Of Appeals For The Second Circuit Dated June 29, 2007 ..... 1a

Appendix B — Memorandum Opinion And Order Of The United States District Court For The Southern District Of New York Dated And Filed July 20, 2006 ..... 4a

Appendix C — Excerpts From The Bankruptcy Court Decision Dated July 7, 2005 ..... 10a

Appendix D — Order Of The United States Court Of Appeals For The Second Circuit Denying Petition For Rehearing Filed September 11, 2007 ..... 15a

Appendix E — Decision Of Arbitrator Of The American Arbitration Association, Commercial Arbitration Tribunal Dated February 8, 2002 ..... 17a

TABLE OF CITED AUTHORITIES

Page

Cases:

Ball v. A.O. Smith Corp.,
451 F.3d 66 (2d Cir. 2006) 14, 15

Boyuka v. White,
128 Fed. Appx. 994 (4th Cir. 2005) 8

Brown v. Felsen,
442 U.S. 127 (1979) ..... *passim*

Carrol v. Quinlivan,
434 F.3d 314 (5th Cir. 2005) 8

Channel Master Corp. v. Aluminum Ltd. Sales,
4 N.Y.2d 403, 176 N.Y.S. 2d 259,
151 N.E.2d 833 5

Davis v Aetna Acceptance Co.,
293 U.S. 328, 55 S. Ct. 151,
79 L. Ed. 393 (1934) 13

Diamond v. Kolcum,
285 F.3d 822 (9th Cir. 2002) 8

Evergreens v. Nunan,
141 F. 2d 927 (2d Cir. 1944) 10

Federal Insurance Company v. Gilson,
250 B.R. 226 (Bnkr. E.D. VA. 2000) 12

Cited Authorities

Page

Fellows, Read & Associates, Inc. v. Rieder,
194 B.R. 734 (1996), aff'd
1997 U.S. App. Lexis 13818 8

Heptacor Inc. v. Luster,
50 Fed. Appx. 781 (7th Cir. 2002) 8

Hoffend v. Villa,
261 F.3d 1148 (11th Cir. 2001) 11

Lama Holding Co. v. Smith Barney Inc. et al.,
646 N.Y.S.2d 76, 88 N.Y.2d 413,
668 N.E.2d 1370 (Ct.App. 1996) 5

Miller v. J.D. Abrams, Inc., (Matter of Miller),
156 F.3d 598 (5th Cir., 1998), *cert. denied*,
526 U.S. 1016, 119 S. Ct. 1249,
143 L. Ed. 2d 347 (1999) 12, 13

New York Univ. v. Continental Ins. Co.,
87 N.Y.2d 308, N.Y.S.2d 283,
662 N.E.2d 763 5

Owens v. Miller,
276 F.3d 424 (8th Cir. 2002) 11, 12

Peoples State Bank v. Crim,
149 Fed. Appx. 427 (6th Cir. 2005) 8

Cited Authorities

Page

Statutes

11 U.S.C. § 523(a)(2)(A) ..... *passim*

11 U.S.C. § 523(a)(4) 13

11 U.S.C. § 523(a)(6) 14

28 U.S.C. § 1927 14

28 U.S.C. § 1254(1) 1

Bankruptcy Act § 17 9

Securities and Exchange Act § 20(a) 11

Fed. R. Civ. Pro. 11 14

Other Authority

4 COLLIER ON BANKRUPTCY,
P 523.10[1][C] (15th ed. rev., 1998) 13

OPINIONS BELOW

The order of the court of appeals denying the petition for rehearing en-banc (App., *infra*, 15a-16a) is not reported. The summary order of the court of appeals (App., *infra*, 1a-3a) is not reported. The district court opinion (App., *infra*, 4a-9a) is not reported. The bankruptcy court decision (App., *infra*, 10a-14a) is not reported. The arbitrator's decision (App., *infra*, 17a-43a) is not reported.

JURISDICTION

The summary order of the court of appeals was entered on June 29, 2007. By order entered on September 11, 2007, the court of appeals denied the Petitioner's timely petition for rehearing en banc (App., *infra*, 15a-16a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Title 11 United States Code, Section 523(a)(2)(A)

Exceptions to Discharge

> (a) a discharge under section 727, 1141, 1228(a), 1228(b) or 1328(b) of this title does not discharge an individual debtor from any debt –
>
> . . .

> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by –
>
> > (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition.

STATEMENT OF THE CASE

This case involves one of the most oft-litigated Bankruptcy non-dischargeability issues. Namely, whether, and under what specific circumstances may a Bankruptcy Court grant summary judgment deeming a debt non-dischargeable based solely on a determination of fraud reached in a prior arbitration proceeding.

In this case, the Second Circuit affirmed the District Court's decision that the Bankruptcy Court did not err in granting summary judgment in favor of Respondent deeming the debt the Petitioner owed to Respondent non-dischargeable based on the decision of fraud reached by an arbitrator. However, the Second Circuit's holding runs afoul of the Court's decision in *Brown v. Felsen*, 442 U.S. 127 (1979) since, according to *Brown*, the only way that the arbitrator's decision could have been given collateral estoppel effect is if the arbitrator's finding of fraud, and the facts related thereto, was based on a standard identical to the standard needed for a finding of fraud under 11 U.S.C. § 523(a)(2)(A) ("Section 523(a)(2)(A)"). However, while the arbitrator did make a finding of fraud, he did so using a different formula, and not the standard used to find fraud under Section 523(a)(2)(A).

Background

The Petitioner was an investment fund manager. In or about 1997, the Respondent invested $2 million in Formula Fund L.L.C. ("Formula Fund"), a hedge fund managed by the Petitioner. In 1998, the Petitioner invested a portion of Formula Fund's assets in an entity known as Amercon International Incorporated ("Amercon"), a company that manufactured aircraft parts. The Petitioner served as the chairman of Amercon's board of directors. In late 1998, shares of Amercon, which were valued at $450 per share, represented 18% of Formula Fund's total portfolio. At the end of 1998 or early in 1999, the Petitioner decided to revalue the Amercon shares to $2,950 per share. This was done during the height of the internet stock boom when many companies who had no revenues and no income were being valued at extraordinary numbers based on their potential. The Petitioner believed that Americon had similar potential upside. After the revaluation, Amercon shares represented more than 50% of the fund's assets.

After having a series of communications with the Respondent with respect to his investment in the fund, in early February, 1999, the Petitioner met with the Respondent in an informal setting and made his case for the Respondent to maintain his investment in the fund. The Respondent, who was a seasoned and savvy investor and was well aware of the risks and rewards associated with these types of funds, decided to keep his money in the fund in the hope of benefitting from the growth potential. When the Respondent ultimately redeemed his investment, he received only $260,631.

As often happens in these situations, as soon as the Respondent sustained losses he immediately turned around to sue the Petitioner. While the Petitioner's management of the fund and assessment of the valuation of the stocks therein may not have been perfect they were certainly not malevolent. Indeed, what happened to the Respondent was going on all over where many sophisticated investors watched their holdings in internet companies and the like turn to dust overnight.

On February 8, 2002, the Respondent commenced arbitration against the Petitioner. On December 1, 2003, before the arbitration hearing took place, the Petitioner filed a petition pursuant to Chapter 7 of the United States Bankruptcy Code. After obtaining relief from the automatic stay, on November 17, 2004, the arbitrator issued an opinion concluding that the Petitioner had committed fraud against the Respondent. *See* App., *infra*, 38a-41a. The Respondent then moved Judge Drain to have his debt excepted from the Petitioner's bankruptcy discharge under Section 523(a)(2). In granting the Respondent's motion, the Bankruptcy Court gave collateral estoppel effect to the arbitrator's fact-finding, and concluded that the Petitioner's actions constituted fraud under New York law. *Id.*, 10a-14a.

While a finding of the elements of common law fraud may typically be given collateral estoppel effect under Section 523(a)(2)(A), the Arbitrator's Decision, by its own analysis, was not based on all the elements of common law fraud.

The Arbitrator's Decision correctly set forth the elements for a common law finding of fraud, as follows:

> "The elements constituting a cause of action for fraud are representation of a material existing fact, falsity, scienter, deception and injury," *New York Univ. v. Continental Ins.* Co., 87 N.Y.2d 308, 318, 639 N.Y.S.2d 283, 662 N.E.2d 763) *citing*; *Channel Master Corp. v. Aluminium Ltd. Sales*, 4 N.Y.2d 403, 176 N.Y.S.2d 259, 151 N.E.2d 833. When the cause of action is based on a material omission, the plaintiff must prove "a material omission of fact which was false and known to be false by defendant, made for the purpose of inducing the other party to rely upon it, justifiable reliance of the other party on the misrepresentation or material omission, and injury. Lama Holding Co. v. Smith Barney Inc. et al., 646 N.Y.S.2d 76, 88 N.Y.2d 413, 668 N.E.2d 1370, (Ct. App. 1996). In New York, a civil fraud must be proven by clear and convincing evidence.

App., *infra*, 38a.

Thus, when a state court makes such factual findings, and indeed if the Arbitrator had made factual findings consistent with those elements of common law fraud, they may be given collateral estoppel effect. However, the Arbitrator did not base his decision on the standards which he himself enumerated. In order to comport with the aforementioned fraud standard, the Decision should have articulated by clear and convincing evidence the elements of a common law fraud, with all of its factual

predicates. Instead, the Arbitrator sets forth an entirely new legal standard not based on the elements of common law fraud.

In that regard, the Decision states:

> However, at the meeting in early February 1999, Dobbs had a duty to disclose truthfully . . . Dobbs not only had a fiduciary duty to disclose by reason of his status as the person who controlled the Fund' Manager, but once he voluntarily undertook to explain the 1998 year-end results to Mehrlich, he assumed a duty to speak truthfully and completely.

Id., 39a-40a. Thus, the Arbitrator based his finding of fraud, not on the elements of common law fraud, but on an entirely new "duty" to disclose. This duty is not part of the standard for a finding of common law fraud and is therefore not a valid basis for a finding of nondischargeability pursuant to Section 523(a)(2)(A). Apparently, the only way the Arbitrator was able to reach his decision was by combining a breach of fiduciary duty standard with some elements of fraud. This, however, does not create the identity of standards required under the Court's decision in *Brown v. Felsen, supra*, in order to create collateral estoppel pursuant to Section 523(a)(2)(A).

The Petitioner argued before the Bankruptcy Court, as well as the District Court and Second Circuit, that the legal standard utilized by the Arbitrator was a convoluted mixture of a breach of fiduciary duty combined with fraud, which, as a matter of law, could not give rise to collateral estoppel.

The Bankruptcy Court as well as the District Court did not fundamentally disagree with the Petitioner's aforementioned argument. Rather, they circumvented the argument by asserting a new legal thesis of "factual" collateral estoppel. The Second Circuit echoed the decisions of the lower courts, and referred to the Court's clear mandate in *Brown v. Felsen, supra,* that collateral estoppel can only be applied in this situation if the factual determinations were reached using standards identical to those needed for a finding of fraud under the Bankruptcy Code, as "dicta". *App., infra,* 2a-3a. In other words, the Second Circuit held, contrary to *Brown,* that even though the legal standards were not identical the factual findings of the arbitrator were sufficient to give rise to collateral estoppel.

REASONS FOR GRANTING THE PETITION

I. The Second Circuit's Decision Conflicts With The Court's Decision In *Brown* Which Established That, Contrary To The Second Circuit's Notion, A Bankruptcy Court Cannot Utilize "Factual" Collateral Estoppel When The Underlying Finding Of Fraud Was Based On A Legal Standard Different Than That Needed For Fraud Under Section 523(a)(2)(A).

Appellant's argument to the lower courts was that, pursuant to *Brown,* the Arbitrator's finding of fraud cannot be given collateral estoppel effect in the bankruptcy court since it was based on a legal standard different than that needed for a finding of fraud under Section 523(a)(2)(A).

The standard for a finding of fraud under Section 523(a)(2)(A) is set forth in *Fellows, Read & Associates, Inc. v. Rieder*, 194 B.R. 734 (1996), aff'd 1997 U.S. App. Lexis 13818, as follows:

> To bar discharge from a debt under Section 523(a)(2)(A), a creditor must prove ... the following factors: (1) the debtor made a representation; (2) he knew the representation was false; (3) he intended to deceive the creditor; (4) the creditor relied on the representation; and (5) his reliance was the proximate cause of his damage.

Id. at 737. *see also Boyuka v. White*, 128 Fed. Appx. 994, 998 (4th Cir. 2005); *Carrol v. Quinlivan*, 434 F.3d 314, 317 (5th Cir. 2005); *Peoples State Bank v. Crim*, 149 Fed. Appx. 427, 430 (6th Cir. 2005); *Heptacor Inc. v. Luster*, 50 Fed. Appx. 781, 784 (7th Cir. 2002); *Diamond v. Kolcum*, 285 F.3d 822, 827 (9th Cir. 2002).

The Arbitrator did not utilize the above standard, but, instead, employed a standard consisting not only of common law fraud, but also breach of fiduciary duty.

In that regard, the Arbitrator stated that it was the Petitioner's failure to discharge his duty to disclose and speak truthfully which led to his finding of fraud. *See, App., infra*, 39a-40a. Apparently, the only way the Arbitrator was able to reach his decision was by combining the legal standards under breach of fiduciary duty with some elements of fraud. This, however, does not create the identity of standards required under *Brown* in order to create collateral estoppel pursuant to Section 523(a)(2)(A).

In point of fact, the Court, in *Brown*, clearly provided that the standard used to find fraud in a proceeding must have been the identical standard used to find fraud for non-dischargeability under the Bankruptcy Code, as follows:

> If, in the course of adjudicating a state-law question, a state court should determine *factual issues using standards identical to those of § 17*[1], then collateral estoppel, in the absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court. (emphasis added).

Id., at 139, note. 10. *See, App., infra*, 2a-3a.

In denying the Appeal, the Second Circuit stated the following regarding the above: "This dicta is merely a general statement that the ordinary prerequisites for application of collateral estoppel apply . . ." *Id.*, 3a.

However, the Second Circuit erred in treating the quoted language as merely a general statement that the "ordinary" prerequisites to collateral estoppel would apply when seeking to utilize collateral estoppel in connection with Section 523(a)(2)(A). In point of fact, *Brown* is precedent that "factual" collateral estoppel may only be utilized by the bankruptcy court in connection with Section 523(a)(2)(A) when there is an identity of standards.

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1. § 17 being the statutory predecessor, under the Bankruptcy Act to § 523 of the Bankruptcy Code.

It is evident that the Second Circuit rejected *Brown*'s more exacting standard for "factual" collateral estoppel in connection with Section 523(a)(2)(A) by their citing to *Evergreens v. Nunan*, 141 F.2d 927 (2d Cir. 1944), a Second Circuit tax case. *App., infra*, 2a. Contrary to the Second Circuit's assertion, it is *Brown* which, subsequently to *Evergreens*, carved out the precedent for "factual" collateral estoppel in connection with Section 523(a)(2)(A).

Thus, *Brown* vitiated any precedential value *Evergreens* may have had at one time in connection with "factual" collateral estoppel and Section 523(a)(2)(A).

Inasmuch as the Second Circuit, tacitly, asserted that the Court in *Brown* did not impose a more exacting standard when invoking collateral estoppel under Section 523(a)(2)(A), the Court should grant certiorari to decide whether the Second Circuit erred, since, on its face, the plain language of the Court in *Brown* does impose the narrower standard, and the Second Circuit's decision and the Court's are in conflict.

II. There Is A Square And Explicit Circuit Conflict On The Important Issue Of When The Bankruptcy Court May Give Prior Determination Of Fraud Collateral Estoppel Effect In Relation To Section 523(a)(2)(A).

The Second Circuit's affirmance of the Bankruptcy Court's finding of fraud based on the Arbitration Award conflicts with the holdings of the Eighth and Fifth Circuits regarding this issue. While the Second Circuit gave the Arbitration Award collateral estoppel effect

even though the arbitrator's finding of fraud was based on a different legal standard mixing elements of fraud with that of breach of fiduciary duty, the Eighth and Fifth Circuits have held that collateral estoppel cannot be applied in this situation since there must be an exact identity of the legal standard for fraud under Section 523(a)(2)(A). Thus, the Circuits are split regarding this issue, and the Court's intervention is needed to, once and for all, clearly define when a prior decision of fraud can be given collateral estoppel effect under Section 523(a)(2)(A) in a bankruptcy proceeding.

For example, in *Owens v. Miller*, 276 F.3d 424 (8th Cir. 2002), the Eighth Circuit held that a finding of fraud under § 20(a) of the Securities Exchange Act (§ 20(a)) can not be extended to Section 523(a)(2)(A). In that regard, the Eighth Circuit stated as follows:

> Section 523 of the Bankruptcy Code addresses actual, traditional fraud, and we are not persuaded that it should be read in such a way as to encompass the nontraditional liability imposed under § 20(a). Like the Eleventh Circuit, we believe that the extension of § 20(a) liability to § 523 of the Bankruptcy Code should come from Congress and not the Judiciary. See Hoffend, 261 F.3d at 1154.

Id. at 429.

Thus, the Eight Circuit's refusal to impute fraud under Section 523(a)(2)(A) by way of § 20(a) since § 20(a) encompasses a standard different from standard under Section 523(a)(2)(A), *i.e.*, common law fraud,

demonstrates a clear conflict with the Second Circuit's holding in this case where the Bankruptcy Court imputed fraud under Section 523(a)(2)(A) by way of the convoluted legal standard for fraud utilized in the Arbitration Award.

In short, the Eighth Circuit holds that only where standards exactly identical to Section 523(a)(2)(A) are used, can a finding of fraud be a basis for a finding of collateral estoppel. The rationale for this is set forth in *Owens*, "We are mindful of our duty to construe exceptions to discharge narrowly . . ." *Id.* In other words, *Owens* stands for the proposition that "fraud" as it is used in Section 523(a)(2)(A), has a specific meaning, and it is not for the courts to extend that meaning to include frauds as they are defined elsewhere, even by statute.

Thus, the Second Circuit's affirmance of a collateral estoppel under Section 523(a)(2)(A) when the finding of fraud was based on a convoluted standard different than fraud under Section 523(a)(2)(A) is a direct conflict with the Eighth Circuit's prior holding on this issue.

In addition, the Second Circuit's holding apparently conflicts with the Fifth Circuit's application of collateral estoppel to the issue of fraud and dischargeability in a bankruptcy proceeding as well. The Fifth Circuit's decision in *Miller v. J.D. Abrams, Inc., (Matter of Miller)*, 156 F.3d 598, 602 (5th Cir., 1998), *cert. denied*, 526 U.S. 1016, 119 S. Ct. 1249, 143 L. Ed. 2d 347 (1999) as interpreted by the bankruptcy court in *Federal Insurance Company v. Gilson*, 250 B.R. 226 (Bnkr. E.D. VA. 2000), provides for the necessity of identity of standards to apply collateral estoppel as follows:

> The Supreme Court pointed out that the elements of a state law fraud or other action may not be the same as the elements of nondischargeability. For example, under § 523(a)(4), fraud by a fiduciary is not dischargeable. But, the nature of a fiduciary under § 523(a)(4) may be different, and narrower, than under state law. Davis v Aetna Acceptance Co., 293 U.S. 328, 333, 55 S. Ct. 151, 153, 79 L. Ed. 393 (1934); Miller v. J.D. Abrams, Inc., (Matter of Miller), 156 F.3d 598, 602 (5th Cir., 1998), cert. denied, 526 U.S. 1016, 119 S. Ct. 1249, 143 L. Ed. 2d 347 (1999); 4 COLLIER ON BANKRUPTCY P 523.10[1][C], at 523-73 (15th ed. rev., 1998).
>
> For these reasons — the waste of resources by creditors, debtors and courts in forcing the litigation of all potential dischargeability issues in every pre-petition collection case for fear that the debtor might file bankruptcy in the indeterminate future; the expertise of the bankruptcy courts in resolving dischargeability issues; and curbing creditor abuse — the Supreme Court declined to give res judicata effect to state court judgments obtained prior to the filing of a petition in bankruptcy. n8

Id. at 238.

Thus, the case at bar, where the Second Circuit gave the Arbitrator's Decision preclusive effect even though the fraud standard used by the Arbitrator is not identical to the fraud needed for Section 523(a)(2)(A), conflicts with the Fifth Circuit.

III. The Second Circuit's Decision In *Ball v. A.O. Smith Corp.* Supports The Petitioner's Argument That An Identity Of Standards Is Required For "Factual" Collateral Estoppel Under Section 523 Of The Bankruptcy Code, And, Thus, The Decision In This Case Conflicts With The Second Circuit's Own Precedent.

Furthermore, the Second Circuit in *Ball*, apparently the very cornerstone of the Summary Order (*See App., infra*, 3a), explicitly expounds the notion that a prior finding can be given "factual" collateral estoppel in a bankruptcy proceeding only if the standard used in the prior proceeding was identical to the standard under the Bankruptcy Code.

In *Ball*, the Second Circuit held that the bankruptcy court properly used a judgment of sanctions in the form of defense costs against an attorney under 28 U.S.C. § 1927 and Rule 11 of the Federal Rules of Civil Procedure to deem the debt nondischargeable under Section 523(a)(6) of the Bankruptcy Code ("Section 523(a)(6)"). The Second Circuit did so despite the fact that the sanctions required a showing that the lawsuit instituted by Ball was "unreasonable and for an improper purpose" while nondischargeability under Section 523(a)(6) requires that the debt be from "willful or malicious injury."

In doing so, the Second Circuit noted that the Fifth Circuit (who imposed the sanction), when deciding whether to award sanctions under § 1927 "has adopted *standards* for such an award *requiring findings that are the equivalent* of malice." *Id.*, at 70. (emphasis added.)

Thus, the Second Circuit, in *Ball*, actually supports the Petitioner's position that, in order to invoke "factual" collateral estoppel, both proceedings must have identical standards.

It follows that the Second Circuit's holding in this case, that affirmed a finding of fraud for non-dischargeability even though the Arbitrator employed a convoluted standard completely different than that needed to establish fraud under Section 523(a)(2)(A), conflicts with its prior holding.

Indeed, *Ball* demonstrates that the Second Circuit has previously followed the precedent in *Brown*, showing that the panel's decision not only conflicts with Supreme Court precedent, but prior Second Circuit holdings as well.

Accordingly, the Court's intervention is necessary to resolve the conflict between the Second Circuit and Eighth and Fifth Circuits, and, indeed, to secure and maintain uniformity in the Second Circuit as well.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

JOSEPH J. HASPEL
THE LAW OFFICES OF
DAVID CARLEBACH
40 Exchange Place
New York, New York 10005
(212) 785-3041

Attorneys for Petitioner

APPENDIX

APPENDIX A — SUMMARY ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED JUNE 29, 2007

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 06-3885-bk

In re: BILLY D. DOBBS Jr.,

Debtor.

BILLY D. DOBBS JR.,

Debtor-Appellant,

v.

RICHARD MEHRLICH,

Appellee.

June 29, 2007

SUMMARY ORDER

PRESENT: Hon. JOSÉ A. CABRANES, Hon. REENA RAGGI, Circuit Judges, Hon. EDWARD R. KORMAN, District Judge*.

Appeal from a judgment of the United States District Court for the Southern District of New York (Denise Cote, *Judge*).

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* The Honorable Edward R. Korman, of the United States District Court for the Eastern District of New York, sitting by designation.

Appendix A

UPON CONSIDERATION WHEREOF, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the judgment of the District Court is **AFFIRMED.**

Debtor-appellant appeals from an August 15, 2006 judgment of the District Court affirming an August 4, 2005 order of the United States Bankruptcy Court for the Southern District of New York (Robert D. Drain, *Bankruptcy Judge*), which deemed debtor-appellant's debt of $751,462.50 plus interest to appellee non-dischargeable under 11 U.S.C. § 523(a)(2)(A). We assume the parties' familiarity with the facts and procedural history of the case.

We review *de novo* the District Court's application of the doctrine of collateral estoppel. *Chartier v. Marlin Mgmt., LLC*, 202 F.3d 89, 93 (2d Cir.2000). Debtor-appellant provides no support, and we have found none, for his argument that collateral estoppel does nothing more than permit "the utilization of the legal conclusion of one court with respect to a given set of facts, by another court." This Court has long recognized the preclusive effect of prior factual findings. *See, e.g., The Evergreens v. Nunan*, 141 F.2d 927, 928 (2d Cir.1944). Nor do we find persuasive debtor-appellant's assertion that dicta in *Brown v. Felsen*, 442 U.S. 127, 99 S.Ct. 2205, 60 L.Ed.2d 767 (1979), changed the fundamental rules of collateral estoppel with respect to § 523. *See id.* at 139 n. 10, 99 S.Ct. 2205 ("If, in the course of adjudicating a state-law question, a state court should determine factual issues using standards identical to those of [the precursor to § 523], then collateral estoppel, in the

absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court."). This dicta is merely a general statement that the ordinary prerequisites for application of collateral estoppel apply, and plaintiff has not explained how the allegedly incorrect analysis used by the arbitrator affected the parties' incentives to litigate the particular facts at issue or rendered those particular facts unnecessary to the arbitrator's decision. *See Ball v. A.O. Smith Corp.*, 451 F.3d 66, 69 (2d Cir.2006). Finally, we think that it was entirely proper for the District Court to decline to consider debtor-appellant's argument, raised for the first time in its reply brief, regarding proximate causation.

We have considered all of debtor-appellant's arguments and find them without merit. The District Court's judgment is **AFFIRMED.**

FOR THE COURT,
Catherine O'Hagan Wolfe, Clerk of Court

By _____
Oliva M. George, Deputy Clerk

APPENDIX B — MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED AND FILED JULY 20, 2006

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

05 CIV. 9817 (DLC)

In re

BILLY D. DOBBS, JR.,

Debtor.

BILLY D. DOBBS, JR.

Appellant,

v.

RICHARD MEHRLICH,

Appellee.

July 20, 2006

MEMORANDUM OPINION & ORDER

DENISE COTE, District Judge:

Appellant Billy D. Dobbs, Jr. ("Dobbs") brings this action to reverse the August 4, 2005 order of Bankruptcy Judge Robert D. Drain (the "Bankruptcy Court Order") deeming Dobbs's debt of $751,462.50 plus interest to appellee Richard Mehrlich ("Mehrlich") non-

dischargeable under 11 U.S.C. § 523(a)(2). Section 523(a)(2) provides that a debtor may not escape liability for a debt obtained by "false pretenses, a false representation, or actual fraud." 11 U.S.C. § 523(a)(2)(A). Dobbs argues that in making his ruling, Judge Drain gave improper collateral estoppel effect to an arbitrator's determination that Dobbs had committed fraud. Mehrlich cross-moves for an affirmance of the Bankruptcy Order. For the reasons set forth below, the Bankruptcy Court Order is affirmed.

The following summary of relevant events is taken from Mehrlich's statement of facts, which Dobbs does not contest. In 1997, Mehrlich invested $2 million in Formula Fund L.L.C. ("Formula Fund"), a hedge fund managed by Dobbs. In 1998, Dobbs invested a portion of Formula Fund's assets in Amercon International Incorporated ("Amercon"), a company that manufactured aircraft parts. Dobbs served as the chairman of Amercon's board of directors. In late 1998, shares of Amercon, which were valued at $450 per share, represented 18% of Formula Fund's total portfolio. At the end of 1998 or early in 1999, Dobbs decided to revalue the Amercon shares to $2,950 per share. After the revaluation, which helped hide Formula Fund's other losses, Amercon shares represented more than 50% of the fund's assets.

Prior to the revaluation, Mehrlich had sent a withdrawal notice to Dobbs. Dobbs did not honor the request. In early 1999, Dobbs sent Mehrlich a quarterly report for Formula Fund, showing a loss of 0.96% for

1998, compared to a gain of 28.55% for the S & P 500 over the same period. On January 19, 1999, Dobbs telephoned Mehrlich and asked him not to withdraw his money from Formula Fund. In early February, Dobbs met with Mehrlich and made his case for Mehrlich to maintain his investment in the fund. He did not tell Mehrlich that Amercon stock represented more than half of Formula Fund's stated value; indeed, he did not mention Amercon at all. Mehrlich decided not to withdraw his capital at that time. When Mehrlich ultimately redeemed his investment, he received only $260,631.

On February 8, 2002, Mehrlich commenced arbitration against Dobbs. On December 1, 2003, before the proceedings had begun, Dobbs filed a petition pursuant to Chapter 7 of the United States Bankruptcy Code. On November 17, 2004, the arbitrator issued an opinion concluding that Dobbs had committed common law fraud against Mehrlich. Mehrlich then moved Judge Drain to have his debt excepted from Dobbs's bankruptcy discharge under Section 523(a)(2). In granting Mehrlich's motion, Judge Drain gave collateral estoppel effect to the arbitrator's fact-finding, and concluded that Dobbs's actions constituted fraud under New York law.

Discussion

A district court "may affirm, modify, or reverse a bankruptcy judge's judgment, order, or decree." Rule 8013, Fed. R. Bankr.P. The court must review the

Appendix B

Bankruptcy Court's findings of fact for clear error and its legal conclusions de novo. *In re Robert N. Kornfield*, 164 F.3d 778, 783 (2d Cir.1999). Here, Dobbs does not dispute any of Judge Drain's factual findings, nor does he contend that an arbitration decision cannot effect collateral estoppel.[1] In making this appeal, he argues simply that the arbitrator applied the wrong standard for fraud, and that Judge Drain erred in giving collateral estoppel effect to the arbitrator's flawed legal conclusion.[2]

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1. In any event, the Second Circuit has clearly held that an arbitration decision may be given collateral estoppel effect

> if the proponent can show with clarity and certainty that the same issues were resolved. Collateral estoppel is permissible as to a given issue if (1) the identical issue was raised in a previous proceeding; (2) the issue was actually litigated and decided in the previous proceeding; (3) the party had a full and fair opportunity to litigate the issue; and (4) the resolution of the issue was necessary to support a valid and final judgment on the merits.

Bear, Stearns & Co., Inc. v. 1109580 Ontario, Inc., 409 F.3d 87, 91 (2d Cir.2005) (citation omitted).

2. In his reply brief, Dobbs argues for the first time that the Bankruptcy Order should be reversed because Judge Drain did not make a finding that Mehrlich's reliance on Dobbs's purported fraud was the proximate cause of the losses. Arguments raised for the first time in a reply memorandum, however, will not be considered. *See Cioffi v. Averill Park Central School Dist. Board of Ed.*, 444 F.3d 158, 169 (2d Cir.2006); *In re WorldCom Sec. Litig.*, 352 F.Supp.2d 472, 494 n. 32 (S.D.N.Y. 2005).

Dobbs's argument is based on an obvious misreading of Judge Drain's opinion, which was delivered orally on July 7, 2005. Dobbs contends that Judge Drain adopted the reasoning of the arbitrator, who, in making his determination that fraud had been committed, referenced Dobbs's "fiduciary duty" to Mehrlich. Dobbs suggests that this reference amounted to the creation of "a new legal standard and obligation . . . out of whole cloth." Judge Drain, however, explicitly disavowed any reliance on the arbitrator's suggestion that Dobbs owed Mehrlich a fiduciary duty, calling the mention "superfluous." Instead, Judge Drain gave collateral estoppel effect only to the *facts* found by the arbitrator. After discussing certain of the arbitrator's factual holdings, he drew his own legal conclusions:

> I find that [the factual] findings by the arbitrator do serve as a basis for the collateral estoppel under Section 523(a)(2)(A). . . . Under New York law, actual fraud may be predicated not only upon an actual misrepresentation, but also a material omission. Such conduct may support a fraud cause of action if the omission was known to the defendant, made with the purpose of inducing the other party to rely on it, and the plaintiff has justifiably relied upon the omission and it has caused injury . . . [T]he arbitrator's reference to a fiduciary duty by Mr. Dobbs on page 20 as the arbitrator himself acknowledges is superfluous given the facts he outlines. *The real duty here* was Mr. Dobbs'[s] duty, having provided partial and

> incorrect information to give Mr. Mehrlich a full picture and not to omit material disclosure with regard to the funds[']investment in Americon and the valuation of Americon. . . .

(Emphasis supplied.)

Dobbs concedes that "a finding of the elements of common law fraud may typically be given collateral estoppel effect under § 523." Furthermore, he does not point to any errors in Judge Drain's legal reasoning. To the extent he means to challenge the existence of a "duty to disclose," however, his argument fails, since New York courts have consistently held that fraud can be committed through omission. *See, e.g., Gaidon v. Guardian Life Ins. Co.*, 94 N.Y.2d 330, 349 (1999).

Conclusion

For the foregoing reasons, the Bankruptcy Court Order is affirmed. The Clerk of Court shall close the case.

SO ORDERED:

Dated: New York, New York
July 20, 2006

s/ Denise Cote
DENISE COTE
United States District Judge

APPENDIX C — EXCERPTS FROM THE BANKRUPTCY COURT DECISION DATED JULY 7, 2005

[Commencing at page 9]

* * *

THE COURT: Okay. All right. I have in front of me a motion for summary judgment by the plaintiff, Mr. Mehrlich, in this adversary proceeding, under Bankruptcy Rule 7056, which incorporates Federal Rules of Civil Procedures 56 C, which provides that summary judgment shall be granted if the pleadings, depositions and answers to interrogatories and omissions on file, together with the affidavit, if any, show, that there's no genuine issue as to a material fact and that the moving party is entitled to judgment as a matter of law.

In deciding a motion for summary judgment, the court must determine if there are any material factual issues to be tried, while at the same time resolving ambiguities and drawing reasonable inferences against the moving party. See 90 versus US Fire Insurance 804 F2d 7911 Second Circuit 1986.

The underlying cause of action here is one under Section 523(a)(2)(a) of the Bankruptcy Code. To determine that Mr. Mehrlich's claim is [10] not dischargeable from Mr. Dobbs' bankruptcy case.

To prevail on such a claim, the plaintiff must show by a preponderance of the evidence the criteria set form in Section 523(a)(2)(a). It should be noted however, that

Appendix C

Section 523 should be strictly construed against the objecting creditor and liberally in favor of the debtor, consistent with the fresh start policy under the Bankruptcy Code. See generally 4 Collier On Bankruptcy paragraph 523.5. Here Mr. Mehrlich relies upon the doctrine of collateral estoppel, which may be invoked in non dischargeability actions on a motion for summary judgment. See Grogan versus Garner at 498 US 279 in 1991, as well as Zois Concrete at 269 BR 89 at 97 Bankruptcy Court Second Circuit Direct of New York 1999.

A party also may be collaterally estopped from relitigating issues that were decided in an arbitration proceeding, which is what Mr. Mehrlich relies on here. See Boguslabsky versus Kaplan 159 F.3d 715, 720 Second Circuit 1998. Collateral estoppel applies if, one, the identical issues was raised in a prior proceeding, the issue was actually litigated and decided in that [11] proceeding, the party had a full and fair opportunity to litigate the issue, and finally, resolution of the issue was necessary to support a valid and final judgment on the merits.

If collateral estoppel is applicable, then the court must also determine if the issue in the prior preceding was identical, if the elements under the particular bankruptcy statute were invoked, and the issues were necessarily decided. See Zois again at 269 B.R. 98. Of course, collateral estoppel applies even if the subject matter in the second proceeding, i.e. non dischargeability is not as the same in the first as long as the elements of collateral estoppel are met.

Appendix C

Here, it should be noted in particular that the arbitrator was fully aware that his decision might be used in a non dischargeability litigation. He makes that point on page two of his decision. I conclude therefore, although I need debt for collateral estoppel to apply, that the arbitrator was particularly careful as to his factual findings as to how they might pertain to a subsequent issue of dischargeability. [12] The statute, Section 523 (a) (2) (a) provides that a debt will be non dischargeable if it is for money, property services, or extension renewal or retention of credit to the extent obtained by false pretenses, a false representation, or actual fraud other than a statement respecting the debtors or insiders financial condition.

It's been noted that the statute's factors are set forth in the disjunctive, and that false pretenses and/or false representation are not necessarily the same as actual fraud. In this case the arbitrator specifically found that there was actual fraud under New York law in connection with Mr. Dobbs' communications with Mr. Mehrlich regarding the funds investment, the formula funds investment in the Americon stock and the value of that investment. He so found on page 19 as well as on page 20, in which he said, "Dobbs not only had a fiduciary duty to disclose by reason of his status as the person who controlled the funds manager, but once he voluntarily undertook to explain the 1998 year end results to Mehrlich, he assumed the duty to speak truthfully and completely. He did not do so. These omissions continued through the fund's [13] incomplete statements in its quarterly reports and in K-1s for 1998 and 1999." He later found on page 22, "if Dobbs had disclosed the Americon Holding and its valuation, Mehrlich

would have withdrawn from the fund at the end of 1998." And he found in his ruling that that fact lead to Mehrlich's damages.

I find that those findings by the arbitrator do serve as a basis for the collateral estoppel under Section 523 (a) (2) (a) in that they were findings on both actual fraud under New York law, as well as false pretenses. Under New York law, actual fraud may be predicated not only upon an actual misrepresentation, but also a material omission. Such conduct may support a fraud cause of action if the omission was known to the defendant, made with the purpose of inducing the other party to rely on it, and the plaintiff has justifiably relied upon the omission and it has caused injury. See Lama Holding Company versus Smith Barney 88 New York 2nd 413-421 1996. A debtor's silence or failure to disclose a material fact may constitute fraud so as to preclude the discharge of the debt in Section 523 (a) (2) (a). See [14] In re Ruppino 221 B.R. at 693 701-03 Bankruptcy Southern District of New York 1998, in re Docktoroff 123 F.3d 210 Third Circuit 1997. In re Eashi 87 F.3d 1002 at 1009, Ninth Circuit 1996, and In re Miller 311 B.R. 227 at 761 District Court of Maryland 2004.

Moreover, Section 523(a)(2)(a) does not require that a person's conduct include the actual false representations or actual fraud is normally required in a classic sense, but rather the disjunct of the statute false pretense makes it clear that that type of conduct fits within the provision as well. See In re Ruppino 221 B.R. at 701. Ordinarily a proof of fraud claim, one would show there was a false representation made that the plaintiff

reasonably or justifiably relied upon it and was injured. In order to show a false pretense, one need not prove the first two elements of a classic fraud, that is, a false representation. However, this does not eliminate the requirement the plaintiff must prove, one, the debtor engaged in conduct that wronged one of his property rights by dishonest methods or schemes such as deprivation of something of value by trick, [15] deceit, chicane or overreaching. In re Ruppino 221 B.R. at 701 quoting Carpenter versus United States 404 US 19-27 1987. The arbitrator's findings therefore also established that Mr. Mehrlich's claim derives from the debtor's false pretense with regard to the investment in the Americon and Americon's value which wrongfully deprived Mr. Mehrlich of his property rights by luring him into remaining in the fund as an investor.

Again, I note making a material omission constitutes fraud under New York law, and in that basis also is satisfied, i.e., believed that the arbitrator's reference to a fiduciary duty by Mr. Dobbs on page 20 as the arbitrator himself acknowledges is superfluous given the facts that he outlines. The real duty here was Mr. Dobbs' duty, having provided partial and incorrect information to give Mr. Mehrlich a full picture and not to omit material disclosure with regard to the funds investment in Americon and the valuation of Americon, either one of which the arbitrator found would have lead Mr. Mehrlich to terminate his investment in the fund.

So based on that, I conclude that [16] the summary judgment motion should be granted.

* * * *

APPENDIX D — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING PETITION FOR REHEARING FILED SEPTEMBER 11, 2007

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
THURGOOD MARSHALL U.S. COURT HOUSE
40 FOLEY SQUARE, NEW YORK, N.Y. 10007

Catherine O'Hagan Wolfe
CLERK OF COURT

Date:

Docket Number: 06-3885-bk

Short Title: In Re: Billy D. Dobbs, Jr. v.

DC Docket Number: 05-cv-____

DC: SDNY (NEW YORK CITY)

DC Judge: Honorable Denise Cote

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 11th day of September two thousand seven.

In re: Billy D. Dobbs, Jr.

Appendix D

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellant Billy D. Dobbs, Jr. Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is **DENIED.**

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT
CATHERINE O'HAGAN WOLFE, Clerk

by s/ Molly A. Guptill
Molly A. Guptill,
Acting Motions Staff Attorney

APPENDIX E — DECISION OF ARBITRATOR OF THE AMERICAN ARBITRATION ASSOCIATION, COMMERCIAL ARBITRATION TRIBUNAL DATED FEBRUARY 8, 2002

AMERICAN ARBITRATION ASSOCIATION
COMMERCIAL ARBITRATION TRIBUNAL

Case No. 13 168 004162

In the Matter of Arbitration Between

RICHARD W. MEHRLICH

Claimant,

-and-

BILLY D. DOBBS, JR. and FORMULA FUND MANAGEMENT, L.L.C.

Respondents.

DECISION OF ARBITRATOR

This arbitration was commenced on or about February 8, 2002 with the filing of a Demand for Arbitration by the Claimant, Richard W. Mehrlich ("Mehrlich"). The Demand seeks compensation for losses suffered in connection with Mehrlich's $2 million investment in Formula Fund, L.L.C. ("Formula Fund" or "the Fund"). Formula Fund is a hedge fund managed by Formula Fund Management, L.L.C. ("Formula-

Management" or "the Manager"). Formula-Management is controlled by the individual Respondent, Billy D. Dobbs Jr. ("Dobbs"). Dobbs made all investment decisions for the Fund. The Respondents, through counsel, filed a Response dated November 25, 2002 denying liability. On the eve of the scheduled hearings on the merits, Dobbs filed a personal bankruptcy petition in the United States Bankruptcy Court for the Southern District of New York, Case No. 03-17622. The filing of the bankruptcy petition triggered the automatic stay provisions of the Bankruptcy Code, and the hearings were adjourned *sine die.* By Order dated January 22, 2004, U.S. Bankruptcy Judge Robert D. Drain modified the automatic stay pursuant to 11 U.S.C. Sec. 362(d) to enable the arbitration to proceed to award. Mehrlich applied to lift the automatic stay in the hope of proving the elements of a non-dischargeable debt under 11 U.S.C. Sec. 523. A reasoned award is, therefore, appropriate.

By the time the stay was lifted, Dobbs was no longer represented by counsel, and he appeared *pro se* through the remainder of the proceedings. In that capacity, Dobbs testified on his own behalf, and examined and cross-examined witnesses. In all, eight witnesses presented testimony over five days of hearings. Hearings on the merits were conducted on April 21 and 22, May 19 and 20 and August 20, 2004. The last hearing was conducted to accommodate the Claimant who called two additional witnesses who did not initially testify in his case in chief. The witnesses who testified were: Kenneth B. Katzman, an expert called by the Claimant;

Beverly Mehrlich, the Claimant's spouse; Richard Mehrlich, the Claimant; Jennifer Wallace, Mr. Dobbs' spouse; Billy Dobbs; John Davenport, Mr. Mehrlich's broker; Joseph Aaron, a principal in the firm of May, Stone & Caddis; and John Reeder, a former friend of Mr. Dobbs and a former director of the offshore hedge fund managed by Mr. Dobbs called Formula Offshore Investment Fund ("Formula Offshore Fund"). Mehrlich also offered deposition transcripts of Dobbs and a Mr. William Schatten, taken in the context of a lawsuit entitled *Halifax Fund, LP v. Formula Offshore Investment Fund, et al.*, (Supreme Court of the State of New York, Index No. 602585/01).

Documents were exchanged by the parties prior to the hearings, and both sides offered documentary evidence in support of their positions.[1] Post-hearing briefs and reply briefs were also exchanged.

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1. In that regard, Mr. Dobbs stated that the Respondents' prior counsel had possession of additional documents perhaps helpful to Mr. Dobbs' case that he was unable to recover. According to Mr. Dobbs, his prior counsel had refused to redeliver the files to Mr. Dobbs, presumably in view of a fee dispute. The Arbitrator notes that, by the time the bankruptcy petition had been filed, both sides had been ordered, and presumably did, make document disclosure, one to the other. In addition, the Arbitrator issued two subpoenas, one directed to Dobbs and Formula Fund and the other to Dobbs' prior counsel for the production of at least some of the allegedly missing documents and for whatever reason, no additional documents were produced. The arbitrator further notes that in the course of the hearings Mr. Dobbs did produce documents from his prior counsel's law office, some of which he said he had obtained with the cooperation of his prior counsel's law partner.

Appendix E

The facts, as demonstrated by the evidence, are as follows:

Mehrlich's Initial Decision to Invest

Mehrlich is a businessman who, in 1980, started a company called Systems Plus, a software publisher, *i.e.* a company in the business of marketing software programs written by others. In or about the end of 1996, Systems Plus merged with a company called Medical Manager. Medical Manager had a software product of its own that it marketed to physicians. In February 1997 the merged company went public in a successful IPO. Mehrlich received cash and a considerable amount of restricted stock. He then decided to diversify by borrowing against the restricted stock that he received in the IPO and investing the proceeds. Mehrlich, an experienced investor, wished to explore hedge funds as possible investment vehicles. Towards that end, he sought recommendations from a trusted stockbroker, John Davenport. Davenport at the time worked in the San Francisco office of Donaldson, Lufkin & Jenrette.

Davenport admittedly knew little of hedge funds and, through a contact at his office, was introduced to one Joseph M. Aaron ("Aaron"). Aaron was the principal of a company named May, Stone & Caddis (MSC). MSC was in the business of introducing hedge fund managers seeking investment capital to potential investors. These introductions were made through seminars or symposia sponsored by MSC. MSC received compensation in the

form of a percentage of the investment funds that it succeeded in introducing to a fund manager.[2]

Aaron, who lived near Davenport, met with him sometime in the summer of 1997. At their meeting, Aaron discussed with Davenport various investment approaches used by hedge fund managers, including the so-called Jones model. That particular approach appealed to Davenport and, based on Davenport's preference, Aaron recommended about 20 fund managers. Dobbs was one of them. Aaron also gave Davenport a booklet that MSC had prepared for use in a July symposium that MSC was sponsoring in Chicago. The book contained a description of the hedge funds that intended to make presentations at the symposium together with a description of the investment managers

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2. While not directly relevant to the ultimate issues raised in this arbitration, Aaron, in January 1996—unbeknownst to Davenport and Mehrlich at the time—was charged in an SEC complaint with violations of Section 17(a) of the 1933 Act and Section 10(b) and Rule 10b-5 of the 1934 Act in connection with the activities of a company called Chartwell Financial. Without admitting or denying the allegations of the complaint, Aaron consented to the entry of an order enjoining him from future violations of Section 17(a) and Section 10(b) and Rule 10b-5. A civil penalty was also imposed. In his testimony, Aaron stated that the SEC consent order was based upon his failure to supervise others and was not the product of any fraudulent activity. Aaron further testified that he made all fund managers with whom he did business fully aware of the prior SEC proceeding. Dobbs observed at the hearings that the name of Aaron's business, "May, Stone & Caddis" was derived from the names of lures used as bait by fly fishermen.

for each fund.[3] Several pages of the booklet were devoted to Formula Fund and Dobbs. The booklet's description of Dobbs included the following: "He does not manage separate accounts nor does he own stocks outside the fund."

Davenport then met with Mehrlich and they reviewed the information and the materials that Davenport had received from Aaron. At their meeting, Davenport and Mehrlich pared the list of potential managers to about 10 or 12. Dobbs was one of the contenders. Both Mehrlich and Davenport testified that Mehrlich relied on, among other things, the representation that Dobbs would not own stocks outside of the fund. Mehrlich testified that this representation "was of great importance" to him because "there [would be] no separate accounts, no game playing ... on the side by managers of the fund by investing in stocks themselves or other activities." (Tr. 530).

After his meeting with Mehrlich, either Aaron or Dobbs arranged a personal meeting between Dobbs and Davenport, and the two met in Davenport's office sometime in the Fall of 1997.

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3. Variants of the booklet that Aaron handed to Davenport were used in three symposia sponsored by MSC. The first symposium was conducted on July 14, 1997 in Chicago, the second on February 17, 1998 in New York, and the third on September 8, 1998 also in New York. Dobbs presented in Chicago and at the second New York symposium.

Davenport was impressed by Dobbs and his stated investment approach. After Davenport did his further diligence on the fund managers, he presented his findings to Mehrlich who eventually decided to invest in six different hedge funds, including Formula Fund Mehrlich then wired $2 million to Formula Fund in December 1997.

In connection with his investment, Mehrlich executed several documents including a Formula Fund L.L.C. Offering Memorandum, Operating Agreement, Subscription Agreement and Investment Suitability Questionnaire.[4]

Formula Fund's Performance Through The Third Quarter of 1998 And Mehrlich's Decision To Redeem

In March 1998 Mehrlich received his K-1 form reflecting his share of the Fund's profit or loss for the month of December 1997, the period in which Mehrlich participated for that year. The K-1 showed a $79,000 loss. Although disappointed, Mehrlich viewed this as part of the risk of investing and took no action to withdraw from the Fund. Through 1998 Dobbs sent Mehrlich quarterly statements purporting to reflect the Fund's

4. Neither side produced executed copies of the investment documents and none were entered into evidence at the arbitration. By Decision dated May 28, 2004, however, the Arbitrator determined by a preponderance of the evidence that Mehrlich in fact executed the documents or was estopped from denying that he had done so.

investment performance. The statements reported that Formula Fund was, net of all fees, up 7.39% in the first quarter of 1998; up 2.54% in the second quarter; down 0.39% in the third quarter; and down 13.01% for the fourth quarter. For all of 1998, the quarterly report dated January 15, 1999 stated that the Fund's annual performance was down 0.96% versus a total return of 28.55% for the S&P 500.

Davenport and Mehrlich monitored the progress of Mehrlich's hedge fund investments, and based on their performance through the third quarter, Mehrlich decided to liquidate or to reduce his exposure in four of the six hedge funds in which he had originally invested. One of the funds he decided to redeem *in toto* was Formula Fund. Thus, on November 12, 1998, Mehrlich, through Davenport, sent a withdrawal notice to Dobbs requesting him to liquidate his limited partnership interest for cash delivery January 1, 1999. Davenport testified that he followed up Mehrlich's letter with a phone call on November 13th in which Dobbs acknowledged receipt of the redemption request and said "no problem" or words to that effect. Mehrlich, again through Davenport, then sent Dobbs a follow up letter on December 17, 1998 giving Dobbs wiring instructions for Mehrlich's account. Davenport also sent a fax to Mehrlich's bank on January 4th alerting the bank to expect wire transfers from the four funds, including Formula Fund, that were the subject of Mehrlich's redemption requests. Of these four funds, all but Formula Fund duly redeemed Mehrlich's investments.

Appendix E

On January 19, 1999 Dobbs telephoned Mehrlich together with one John Reeder, who, according to the Fund's January 1999 quarterly report, had joined Formula Fund as an analyst earlier that month. In that call, Dobbs asked Mehrlich why he wanted to redeem. Also in that conversation, which was followed-up with a letter from Dobbs of the same date, Dobbs asked Mehrlich to postpone his redemption pending a meeting at which Dobbs could fly out to speak to him to present reasons why Mehrlich ought to remain invested in the Fund. In his follow-up letter Dobbs confirmed that Mehrlich, in their conversation, agreed to "table your decision to redeem your investment in Formula Fund LLC pending an in-person visit by us . . ." (Claimant's exhibit 31). If Mehrlich continued with the Fund, the letter also offered an "8% hurdle-rate" as a condition to Dobbs' earning any performance fees. The letter went on to express optimism in the future and stated, "With the exception of a tricky October [1998], we are encouraged by our twenty-two month historical performance." *Id.* The Formula Fund quarterly report dated January 15, 1999 was attached to the letter of January 19th. It reflected a negative 21.33% performance for October 1998.

Formula Fund's Investment in Amercon

Meanwhile, early in 1998 events began to unfold that had a significant bearing on the direction and future of Formula Fund. In February 1998 Dobbs invested both his own personal funds and those of Formula Fund in a start-up company that manufactured aircraft parts

named Amercon International Incorporated ("Amercon"). Originally, Dobbs, for his own account, purchased 189 shares of Amercon in its initial offering at $450.00 per share, and caused Formula Fund to purchase 1,464 shares of Amercon, also at $450.00 per share. Either at that time, or shortly thereafter, Dobbs also became Chairman of Amercon's Board of Directors.

Amercon sold a small number of additional shares (549 shares in total) in or about October of 1998 at a price of $1,825.00 per share. Dobbs purchased additional shares at that time for his own account and caused Formula Fund to buy additional shares as well. The 1998 year-end brokerage statement for Formula Fund (Claimant's exhibit 12) reflects that Formula Fund held, at the end of 1998, 1,611.22 shares of Amercon carried at a cost of $450.00 per share. This totaled $725,050.00, a sum that represented about 18% of Formula Fund's total portfolio at cost (and about 12% of its total long positions at cost) at year end 1998.[5]

Mehrlich testified that, at the time he decided to invest in Formula Fund, he had assumed that the vast percentage of the Fund's trading was done in publicly traded securities. He testified that he had little interest in investing in a hedge fund that would purchase privately held, illiquid securities. After all, Mehrlich was

5. According to the brokerage statement, Formula Fund's portfolio value at cost on 12/31/98 was $4,044,899.59 calculated by taking Formula Fund's long positions, at cost, totaling $6,196,639.32 and subtracting the Fund's short positions of $552,866.17 and subtracting its cash of $1,598,873.56.

motivated to diversify because of the concentration of his wealth in a block of restricted stock that he obtained in the Medical Manager IPO in early 1997. Both Mehrlich and Davenport also testified that the statement attributed to Dobbs in the MSC booklet that Dobbs would not own stock outside of the Fund was a *sine qua non* of Mehrlich's decision to invest.

Dobbs on the other hand, denied that he authored the statements in the MSC booklet or authorized Aaron to make them on his behalf (something Aaron strongly contested in his testimony), Dobbs also pointed to Article 6.1(c) of the standard Formula Fund L.L.C. Operating Agreement, a document presumably executed by Mehrlich.[6] That Section states that "The Manager [Formula-Management] shall use its best efforts to carry out the objectives and purposes of the [Fund] ... provided, however, that nothing contained in this Section 6.1 shall preclude the Manager or any affiliate of the Manager ... from trading in securities for his own account."[7] Further, while the "Summary of Offering" set forth in the Fund's Offering Memorandum, entered into evidence as Respondent's exhibit 3, states under the

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6. The exhibit entered into evidence, Respondent's exhibit R-1, is a copy of the Operating Agreement between Dobbs and Formula Fund L.L.C. As set forth above, Mehrlich presumably executed this standard form as well, even though investment documents signed by Mehrlich were never offered into evidence.

7. A similar statement appears on page 23 of the Offering Memorandum under the heading "Potential Conflicts of Interest."

heading "Investment Policies" that the fund will invest "principally in the stock of U.S. public companies", the paragraph continues as follows: "The [Fund] may also invest to a lesser extent in private investment companies . . ." Mehrlich acknowledged in his testimony that he would not have felt aggrieved if the Fund had invested some of its assets in a private placement (and, indeed, later in 2000 did not express surprise by the fact that the redemption of his interest might involve the transfer to him of restricted securities, *see* Claimant's exhibit 37). However, his consistent expectation was that the Fund would dominantly trade publicly listed securities.

It is undisputed, however, that Formula Fund—by the end of 1998—owned a substantial stake in Amercon. It is also undisputed that these securities were carried at a price of $450.00 per share until Dobbs, sometime towards the end of 1998 or the beginning of 1999 decided to revalue them.

The Revaluation of Amercon

It appears from the quarterly statements sent by Dobbs that 1998 was a difficult year for the Fund. According to the January 1999 statement that valued the Fund's full year 1998 performance, Formula Fund lost 0.96% for the year versus a positive return of 28.55% for the S&P 500. Indeed, the Fund reportedly suffered a negative 21.33% performance in the month of October 1998 alone.

Appendix E

John Reeder testified, however, that the Fund's performance in 1998 was far worse than that communicated to its investors. Reeder was a personal friend and classmate of Dobbs who Dobbs employed for a short while beginning in early 1999. Reeder was ostensibly hired as an analyst, but essentially worked editing a Fund newsletter and assisted in Dobbs' attempts to raise additional capital. Reeder and Dobbs were part of a network of Columbia Business School classmates who remained friends and who continued to network after their graduation. Reeder's brother was an investor in Amercon and Dobbs recruited Reeder as a Director of the Formula Offshore Fund, where Reeder served until his resignation in September of 1999.

According to Reeder's testimony, Dobbs suffered a 55% trading loss in October of 1998 and not the lesser 21.33% loss reported on the Fund's quarterly report. Reeder further testified that Dobbs, knowing that the reporting of that loss would spell doom for the Fund, concealed the October loss by revaluing upwards the Amercon stock held by the Fund. The 1998 year end brokerage statement for the Fund (Claimant's exhibit 12) recites the "Market Value" of the Fund's 1,611.22 Amercon shares as $4,753,105.49 or $2,950.00 per share. A valuation of $2,950.00 per share enabled the Fund to report a 21.33% loss in October and a near break-even performance for the year.

Dobbs acknowledged that he placed the $2,950.00 valuation on the Amercon stock in a letter dated April 2, 1999 to BDO Seidman, the Fund's accountants.

In that letter, he sought to explain his valuation as follows: "The $2,950 per share valuation of Amercon International reflects an approximately 16% discount to the equity offering in February 1999 of $3,500 per share. . . . The $3,500 price per share was determined by using a multiple of 3.5x Q4 run rate EBITDA . . ." (Claimant's exhibit 13). Dobbs defined the phrase "Q4 run rate EBITDA" as the prediction for Amercon's fourth quarter 1999 cash flow.

At the hearings Dobbs sought further to justify his upward valuation of Amercon in a number of ways. He pointed out that the valuation of a privately held security is not an exact science and that using a multiple of assumed future cash flow was one way to arrive at a fair value. He also stated that, in early 1999, Amercon conducted an offering at $3,500.00 per share. An exhibit proffered by Dobbs (Respondent's exhibit 11A) consists of a form letter addressed to "Dear _____" and dated "____ date ____, 1999". It purports to offer 286 shares of Amercon stock at $3,500.00 per share. Additional exhibits are consistent with a 1999 offering at $3,500.00 per share. *See, e.g.*, Claimant's exhibit 17 at page 11. The record, however, is unclear as to whether any Amercon shares were actually sold to investors at that price, and, if so, how many. Further, the total number of shares offered was quite small, A letter to Amercon shareholders dated November 4, 1999 offering 22,604 shares of Amercon at $35.40 per share (exhibit 7 to the deposition of Mr. Dobbs taken in the *Halifax* litigation, part of Claimant's exhibit 10) contains a section entitled "PRIOR OFFERINGS". No prior offering at $3,500.00 per share is listed.

Appendix E

Dobbs, in order to justify the valuation that he had placed on the Fund's Amercon shares, also referred to Section 3.7 of the Operating Agreement which provides: "[S]ecurities for which market prices are not readily available . . . are valued at fair market values determined in good faith by the Manager. Notwithstanding the foregoing, the Manager reserves the right to determine the fair market values of all assets held by the [Fund] using reasonable valuation techniques other than as stated above, provided that any such determination shall be based on the Manager's good faith determination regarding the reasonableness of such values. The values . . . determined by the Manager shall be final and conclusive."

Mehrlich claimed that Dobbs made the upward valuation in bad faith in order to conceal the Fund's poor performance and in order to generate management fees. Dobbs, as explained above, argued that the valuation was justifiable at the time especially with reference to a privately held, illiquid security. Whatever the motivation, the upward valuation of Amercon increased the value of the Amercon holdings on the books of Formula Fund from $725,050.00 (at $450.00 per share) to $4,753,105.49 (at $2,950.00 per share). It also made the Fund's Amercon stock holding equal to over 50% of the Fund's assets as of the end of 1998.

Appendix E

Dobbs' Meeting With Mehrlich

It was against this background that Dobbs and Reeder met with Mehrlich in California in early February 1999 in an attempt to dissuade Mehrlich from redeeming his investment in the Fund. The meeting was attended by Mr. and Mrs. Mehrlich, Dobbs, Reeder and Davenport. It lasted about two hours. Mehrlich reiterated his disappointment with the Fund's lackluster performance. Dobbs sought to reassure him. Dobbs and Mehrlich discussed the Funds' investment in a small golf equipment company named Coastcast and its potential for substantial gain. Dobbs reiterated his offer of an 8% hurdle rate that the Fund would have to achieve before Dobbs could earn a management fee. Dobbs also explained reasons for the trading errors that resulted in the Fund's poor October performance and talked about instituting a new matrix trading system that the Fund would use to avoid the undue concentrations in particular market sectors that had led to the October trading losses. Dobbs also promised to participate in monthly telephone calls with Mehrlich to keep him apprised of the Fund's performance and any new developments.

According to the Mehrlichs, Davenport and Reeder, Dobbs never once mentioned Amercon at the meeting, nor the fact that, at the year-end value he had ascribed to the stock, Amercon represented well over half of Formula Fund's stated value. The Mehrlichs and Davenport testified that at no time did they know or suspect that Formula Fund held a substantial position in a non-public illiquid security, nor, of course, were they

aware of the percentage value of the Fund represented by the Amercon stock. Reeder testified that he himself was unaware of the extent of the Fund's investment in Amercon—or the percentage of the Fund represented by Amercon— until some weeks after the meeting with the Mehrlichs and Davenport.

Relying on what he had heard from Dobbs at the meeting, Mehrlich withdrew his total redemption request and decided instead to withdraw only $500,000. By letter dated February 8, 1999 (Claimant's exhibit 32) Dobbs agreed to send Mehrlich a check for $500,000 in the first week of March. Mehrlich subsequently received his K-1 for 1998 (Claimant's exhibit 21). Because of the upward valuation of Formula Fund's Amercon stock, the K-1 showed a reduction of only $29,063 in Mehrlich's capital account for 1998 leaving a year-end balance of $1,891,559. In addition, Mehrlich continued to receive quarterly reports. Two of them, one dated July 15, 1999 and the other dated October 15, 1999 were entered into evidence (part of Claimant's exhibit 33).[8] Neither of the quarterly reports disclosed the Amercon investment although each of them contained detailed descriptions of "Some Current Long Positions." In view of the small loss reported in the K-1 for 1998 and the optimistic quarterly reports received in 1999, Mehrlich did not press his request for a $500,000 withdrawal and Dobbs never sent it.

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8. No first quarter 1999 quarterly report was entered into evidence, but this may have been simply due to the fact that none surfaced in the course of document production. Presumably, a first quarter 1999 report was issued.

Appendix E

Dobbs' Continuing Valuation of Amercon Through 1999 and 2000

The $2,950.00 per share valuation that Dobbs originally made in late 1998 or early 1999 was maintained throughout 1999 and 2000. One exhibit, Claimant's exhibit 39A, reflects a valuation of $2,950.00 per share, or higher, for the Formula Offshore Fund in the latter months of 2000, and the clear inference is that the domestic fund, *i.e.* Formula Fund, was valued using the same numbers. The continued use of the $2,950,00 (or higher) figure is also confirmed by another Claimant's exhibit. According to Claimant's exhibit 24, which is Formula Fund's capital account summary for the year ended December 31, 1999, at least six investors redeemed their capital in 1999. The names of these investors were redacted in the exhibit when it was produced and during his testimony Dobbs was asked whether he could identify the investors who redeemed. He said that he could not recall and that the accountants had prepared the original exhibit.[9] Three of the six Formula Fund investors who redeemed in course of 1999 received amounts greater than their opening capital. The other three were able to redeem at least 90% of their

9. The Claimant had speculated that Dobbs cashed out his friends while leaving Mehrlich and other less favored investors to suffer the ultimate loss. Dobbs denied that this occurred. Further, Jennifer Wallace, Dobbs' spouse, testified that she remained in the Fund during that period as did other family members. The arbitrator issued two subpoenas which were sent to the parties calling for Dobbs, Formula Fund and Dobbs' prior counsel to disclose the unredacted exhibit. The unredacted exhibit never appeared at the hearing.

opening 1999 capital as reflected on exhibit 24, thus indicating that Amercon was carried at the same or substantially the same share value through at least the end of 1999.

This $2,950.00 per share (or higher) valuation persisted despite additional Amercon stock offerings in 1999 and 2000 at share prices substantially below $2,950.00 per share, coupled with a poor financial performance by the company that would appear to have destroyed any justification for the $3,500.00 per share figure on which the $2,950.00 valuation had been based. In late October 1999 the Amercon shareholders conducted an offering to sell up to 22,604 shares at only $35.40 per share. The shareholders made that determination in a document entitled "AMERCON ... STOCKHOLDER ACTION BY WRITTEN CONSENT IN LIEU OF A MEETING" ("the Written Consent") (Exhibit 11 to the deposition of Mr. Dobbs conducted in the *Halifax* litigation, part of Claimant's exhibit 10). The Written Consent contains the following paragraph:

> WHEREAS, the Stockholders estimate that the fair market value of the Corporation's outstanding common stock is $200,000, or $35.40 per share, and wish to price the private placement on that basis;

There is a signature line for Dobbs' signature on the Written Consent. Dobbs' signature, however, does not appear. In his deposition testimony in the *Halifax* litigation, Dobbs testified that he did not recall signing

the document but that he had no reason to believe he did not sign it (*Halifax* dep. tr. 146). A letter subsequently sent on Amercon letterhead addressed "Dear Bill" reiterates the $35.40 per share offer and includes the following statement: "As you know, over the last several months, Amercon has suffered from and continues to suffer from severe financial difficulties. These difficulties have put Amercon's viability as a going concern into real doubt." (Claimant's exhibit 16). Another offering dated February 18, 2000 sought to sell up to 6,250 Amercon shares at $80.00 per share. Both of those offering prices were a far cry from $3,500.00 per share and, of course, Amercon never achieved a fourth quarter 1999 EBITDA that would have justified the $3,500.00 offering price that Dobbs had initially used to arrive at his $2,950.00 per share valuation.

Mehrlich's Renewed Decision To Redeem

Still unaware of the very existence of an investment called Amercon, but disappointed that Formula Fund had not realized his expectations, Mehrlich decided to redeem $1,000.000.00 of his investment at the end of 1999. On December 6, 1999 Mehrlich sent a letter to Dobbs requesting his funds (Claimant's exhibit 19). Davenport testified that he pressed Dobbs for the funds in early 2000 but that Dobbs either put him off or was unavailable to take his calls. In or about March of 2000 Mehrlich then received his K-1 for 1999 (Claimant's exhibit 22). It showed an increase of $436,791 in his capital account. Pleased with the Fund's 1999 performance as reflected on the K-1, Mehrlich did not insist on the return of the $1,000,000 that he had previously requested.

Appendix E

As 2000 progressed, Mehrlich, thinking that was receiving a "decent return" (Tr. 605) continued with Formula Fund. After April 2000, however, he no longer received any quarterly reports, and his phone contacts with Dobbs became infrequent. Towards the end of 2000 he decided finally to redeem his investment. On October 26, 2000 Mehrlich, again through Davenport, sent a letter to Dobbs requesting a full redemption. A follow-up request was subsequently sent. (Claimant's exhibit 37). Mehrlich states in his letter of October 26th that be understands "that a certain portion of the funds may he in restricted securities". *Id.* Mehrlich testified (Tr. 614-615) that, as far as he was aware, the "restricted securities" to which he referred related to a possible position in Coastcast. At that point Mehrlich had still never heard of Amercon.

Finally, in February 2001 Mehrlich received $260,631 in full redemption of his $2,000,000 investment. A letter from Dobbs to Mehrlich dated February 12, 2001 (Claimant's exhibit 26) informing Mehrlich that his capital had been wired to him pursuant to his instructions expressed regret at the Fund's weak performance. The chart in the letter reflected a total loss in 2000 of over 88% and a loss in November alone of 71.37%.

Mehrlich testified that the first time he became aware of significant losses in the Fund was when he received his $260,631 and the accompanying letter that announced the losses. According to the testimony at the hearing, the downward valuation of Amercon and the revelation of the loss was triggered by a demand from

BDO Seidman, the Fund's accountants, that the Amercon investment be revalued to reflect its fair value.

This arbitration followed.

Legal Analysis

Mehrlich claims that the events described above constitute a fraud. "The elements constituting a cause of action for fraud are 'representation of a material existing fact, falsity, scienter, deception and injury.'" *New York University v. Continental Insurance Co.*, 87 N.Y.2d 308, 318, 639 N.Y.S.2d 283, 289 (Ct. App. 1995) *citing, Channel Master Corp. v. Aluminum Ltd. Sales, Inc.*, 4 N.Y.2d 403, 407, 176 N.Y.S.2d 259 (Ct. App. 1958). When the cause of action is based upon a material omission, the plaintiff must prove "a material omission of fact which was false and known to be false by defendant, made for the purpose of inducing the other party to rely upon it, justifiable reliance of the other party on the . . . material omission, and injury." *Lama Holding Co. v. Smith Barney Inc.*, 88 N.Y.2d 413, 421, 646 N.Y.S.2d 76, 80 (Ct. App. 1996). In New York, a civil fraud must be proven by clear and convincing evidence.[10]

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10. The Fund is a Delaware company, Mehrlich is a California resident, and Dobbs operated the Fund out of New York. New York was also the place of arbitration. This award analyzes the facts with reference to New York substantive law. California and Delaware have the same elements of a fraud, however, and the analysis would be the same. Further, to the extent that Dobbs' actions can he characterized as securities fraud, the essential elements would also be the same, albeit with certain added requirements, *e.g.* that the fraud be committed "in connection with" the purchase or sale of a security, etc.

Appendix E

I find that the Claimant has proven the elements of a fraud as follows:

1. Dobbs' initial purchase of Amercon for the Fund and for his own account did not constitute a fraud *per se*. Mehrlich was aware or should have been aware that Formula Fund might trade in such securities, and no evidence was offered that Dobbs' personal interest in Amercon, or any trading of that personal interest, constituted self-dealing to the detriment of either Mehrlich or the Fund. As for the purchase of a privately held security, Mehrlich testified that he would not have felt aggrieved had he known that the Fund had taken a position in restricted stock and in his letter of October 2000 (exhibit 37) he states that he understood that part of his redemption might consist of restricted securities. While the statement attributed to Dobbs in the MSC brochure was untrue, Mehrlich did not rely upon it, at least to the extent that it promised that Formula Fund would never hold an illiquid security.

2. However, at the meeting in early February 1999, Dobbs had a duty to disclose truthfully the extent of the Fund's exposure in Amercon and the fact of the revaluation. At the value that Dobbs had ascribed to it, Amercon, an illiquid privately held security, represented well over half of the Fund's

stated value. Mehrlich had a right to know that fact before he decided to withdraw his redemption request and retain his investment. Dobbs not only had a fiduciary duty to disclose by reason of his status as the person who controlled the Funds' Manager, but once he voluntarily undertook to explain the 1998 year-end results to Mehrlich, he assumed a duty to speak truthfully and completely. He did not do so. These omissions continued through the Fund's incomplete statements in its quarterly reports and in the K-1s for 1998 and 1999.

3. I find that Dobbs' upward valuation of Amercon to $2,950.00 per share was done in bad faith to conceal the losses that would have otherwise come to light in 1998. Perhaps not coincidentally, Dobbs also earned substantial fees by reason of the upward valuation. A value of $2,950.00 per share was unjustified by any reasonable view of the state of Amercon or its future prospects. Indeed, the letter of November 4, 1999, discussed above, in a section entitled "PRIOR OFFERINGS" never even mentions a $3,500.00 per share offering. Even assuming, *arguendo*, that that valuation could have been justified at the time it was initially made, it would have been apparent at least by mid-1999 that the valuation was wildly inflated. Dobbs' failure

to revalue downward the Fund's Amercon holdings through all of 1999 and 2000 and his dissemination of incomplete quarterly reports supposedly reflecting the Fund's actual performance through 1999 and 2000 constituted a continuing deception.

4. Dobbs' wrongful upward revaluation of Amercon caused Mehrlich to believe that the Fund's 1998 losses were modest when in fact they were not. Mehrlich was deceived, and he reasonably relied upon Dobbs' failure to disclose by withdrawing his 1998 redemption notice and remaining in the Fund.

5. Mehrlich was damaged as calculated below.

The Damages

The Claimant is not entitled simply to the return of his initial investment of $2,000,000. The evidence is insufficient to demonstrate that Dobbs solicited the funds by fraudulent means. Some of the statements in the MSC materials proved to be untrue, but there is no clear and convincing evidence that they were made with the intent to deceive especially in view of the reservations set forth in the investment documents.

In addition, the Fund's mere purchase of Amercon, a privately held security, did not damage Mehrlich. There was no evidence that Dobbs personally profited from purchases or sales of Amercon stock (although the upward

valuation of the stock generated management fees). Further, I credit the testimony of Jennifer Wallace, Dobbs' spouse, to the effect that she herself lost money in the Fund as did several of Dobbs' own relatives. Dobbs clearly wanted the Fund to succeed. His error was in the investment decisions that he made and the ill-conceived efforts to buy time by over-valuing Amercon and then failing to disclose that investment and that valuation to his investors.

The measure of damages for fraud is "indemnity for the actual pecuniary loss sustained as the direct result of the wrong." *Lama Holding Co.*, *supra.*, 646 N.Y.S.2d at 80. If Dobbs had disclosed the Amercon holding and its valuation, Mehrlich would have withdrawn from the Fund at the end of 1998. His damages, therefore, are measured by the amount that he would have properly received had he withdrawn at the end of 1998 less what he ultimately did receive in 2001.

Mehrlich's K-1 for 1998 showed an ending capital account of $1,891,559. On exhibit 24, one investor—obviously Mehrlich—shows an opening capital account of $1,891,360.[11] Exhibit 24 shows total capital for Formula Fund as of the end of 1998 of $7,217,355. Thus, as of the end of 1998 Mehrlich had a 26.21% interest in the Fund ($1,891,360/$7,217,355).

Claimant's exhibit 12, the brokerage account summary for the year end 1998 values the total portfolio at cost at $4,044,900. The Fund, valued at market, but including Amercon valued at $450 per share, which I find to be fair

11. The exhibit is only partially legible and the digits are not completely clear.

value, is equal to $3,619,826, *i.e.* $7,647,881 (the total market value reflected on exhibit 12) less $4,028,055 (the excess of Amercon's value as valued by Dobbs over cost).

Thus, if Mehrlich had redeemed his interest in Formula Fund for value as at December 31, 1998, he would have received $948,756, or 26.21% of $3,619,826. Instead, Mehrlich received only $260,631.

I therefore find that Mehrlich sustained damages of $688,125 ($948,756 less $260,631).

Mehrlich would receive less if his damages were measured as of the end of 1999 or 2000. As explained at the text accompanying footnote 9 above, six investors withdrew or redeemed about $1,000,000 in 1999 (Claimant's exhibit 17, at page 8, reflects that $982,556 in Capital withdrawals occurred in 1999). The funds that Formula Fund utilized to pay for these six redemptions had to come from the liquidation of publicly traded securities in the Fund's portfolio. This would have had the effect of aggravating an already untenable situation by arithmetically increasing the percentage of the total portfolio value represented by Amercon and depleting the Fund's inventory of liquid securities available to pay redeeming investors.

It is therefore appropriate to assess damages as of the end of 1998.

86

No. 07-801

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IN THE

Supreme Court of the United States

BILLY D. DOBBS JR.,

Petitioner,

v.

RICHARD MEHRLICH,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION

NORMAN SOLOVAY
HARTMAN & CRAVEN, LLP
488 Madison Ave, 16th Floor
New York, NY 10022
(212) 754- 6915

ISAAC NUTOVIC
Counsel of Record
NUTOVIC & ASSOCIATES
488 Madison Ave, 16th Floor
New York, NY 10022
(212) 421-9100

Attorneys for Respondent

214208

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

QUESTIONS PRESENTED

I. Whether Petitioner has presented any compelling reason to grant the Petition, where the Second Circuit's opinion affirming the District Court's affirmance of the Bankruptcy Court's grant of summary judgment does not conflict with a decision of this Court or a Court of Appeals and where Petitioner does not claim the Second Circuit's ruling implicates an important federal question that has not been settled.

II. Whether Petitioner has presented any compelling reason to grant the petition, where the Second Circuit's opinion articulated principles of collateral estoppel consistent with this Court's prior rulings and Petitioner is complaining merely that those principles were not properly applied.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
TABLE OF CONTENTS	ii
TABLE OF CITED AUTHORITIES	iv
INTRODUCTION	1
STATEMENT OF CASE	1
REASONS FOR DENYING THE PETITION	6
I. Collateral Estoppel Was Properly Applied To An Arbitration Award Made After Extensive Hearings	6
II. None Of The Decisions Of The Three Courts Is In Conflict With This Court's Decision In *Brown v. Felsen*	9
III. Petitioner's Claim That A Conflict Between Circuits On The Subject Matter Of This Case Requires This Court's Intervention Is Unsubstantiated	12

Contents

Page

IV. Petitioner's Claim That Review By This Court Is Warranted Because The Second Circuit Opinion Conflicts With Other Second Circuit Decisions Is Preposterous 15

CONCLUSION 17

APPENDIX A — SWORN DECLARATION OF JOHN REEDER DATED AUGUST 12, 2004 ..... 1a

TABLE OF CITED AUTHORITIES

Page

Cases:

Ball v. A-O- Smith Corp.,
451 F.3d 66 (2nd Cir. 2006) 15, 16

Brown v. Felsen,
442 U.S. 127 (1979) 1, 9, 10, 11, 12

Evergreen v. Nunan,
141 F.2d 927 (2d Cir. 1944) 11

Grogan v. Garner,
498 U.S. 279 (1991) 11

Miller v. J.D. Adams, Inc.,
156 F.3d 598, 602 (5th Cir. 1998), *cert denied*,
526 U.S. 1016 (1999) 12, 14

Owens v. Miller,
276 F.3d 424 (8th Cir. 2002) 12, 13

Statutes:

11 U.S.C. § 35 10

11 U.S.C. § 523 ..... 11, 15

11 U.S.C. § 523(a)(2)(A) 10

11 U.S.C. § 523(a)(4) ..... *passim*

Cited Authorities

	Page
11 U.S.C. § 523(a)(6)	15
Bankruptcy Act § 17	10
Rule:	
Sup. Ct. R. 10	1

INTRODUCTION

Petitioner, Dobbs, has presented no "compelling reason" for his Petition For A Writ of Certiorari ("Petition"), which is the standard for granting the Petition. *See* Sup. Ct. R. 10. In his Petition, Petitioner posits that there is a conflict between the Second Circuit's ruling and this Court's decision in *Brown v. Felsen*, 442 U.S 127 (1979); that there is a conflict with the other courts of appeal in the Fifth and Eighth Circuits on the same matter; and there is a conflict between the Second Circuit Opinion and other Second Circuit precedent. None of this is true. The Second Circuit and the two lower courts merely applied traditional principles of collateral estoppel in a routine fashion. Petitioner does not contend that these courts articulated standards inconsistent with any other courts; rather Petitioner's argument is that all three Courts misapplied these settled principles when dealing with the particular facts here. Dobbs in incorrect, but even if he is the Petition should be denied. As expressly noted in Sup. Ct. R. 10 the misapplication of law to facts rarely provides grounds the Court's review. There is no reason to depart from the usual rule here.

STATEMENT OF CASE

In 1997, Mehrlich invested $2 million in Formula Fund L.L.C. (the "Fund") — a hedge fund managed by Billy D. Dobbs ("Dobbs or Petitioner"). Shortly before the Fund's demise, its accountants compelled it to revise Dobbs' formerly favorable written and oral financial reports and optimistic claims, thus, for the first time, disclosing that Mehrlich's investment had been essentially wiped out.

On February 8, 2002, Mehrlich initiated an arbitration. By a variety of dilatory tactics, Dobbs was able to drag out proceedings in it for almost three years. At the end of that time, however, a highly experienced arbitrator (Robert Davidson, then a partner in Baker & Mackenzie, now the New York Executive Director of the Arbitration Practice of JAMS, Inc.) handed down a carefully considered Decision and Award dated November 17, 2004 holding Dobbs guilty of various kinds of fraudulent conduct.

The Decision refers to Dobbs' filing of a bankruptcy petition "on the eve of the scheduled hearings on the merits." However, prior to those hearings extensive evidentiary hearings had already been conducted. What probably sparked the bankruptcy filing was the reopening of evidentiary hearings to accommodate the proffered newly available testimony of a witness, John Reeder. That testimony, when ultimately presented after the bankruptcy stay was lifted, eliminated any conceivable doubts that might have previously existed about Dobbs' guilt of a clear, willful and continuing course of grossly fraudulent misconduct.[1]

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[1] In a sworn declaration dated August 12, 2004 (Appendix A, annexed hereto) subsequently confirmed in testimony before the arbitrator, Reeder, a former close friend who had gone to work for Dobbs' fund, detailed how and when he had become aware of Dobbs' course of deliberately fraudulent and deceptive misconduct towards Mehrlich and other investors and how he (Reeder) had confronted Dobbs and then parted company with him when Dobbs had ignored Reeder's urging that he "come clean."

This extensive record before the arbitrator based on the following clear and incontrovertible facts[2]; made it clear that Dobbs' conduct was grossly fraudulent no matter what legal standard it was measured by:

In February 1998, after Mehrlich had become an investor in Dobbs' hedge fund, Dobbs invested a portion of the Fund in a start-up company named Amercon International Incorporated ("Amercon"). Dobbs then became Chairman of Amercon's Board of Directors. At the end of 1998, the Fund held 1,611.22 shares of Amercon carried at a cost of $450.00 per share. This totaled $725,050.00, a sum that represented about 18% of the Fund's total portfolio at year end 1998.

The Amercon securities were carried on the Fund's books at the cost price of $450.00 per share until the end of 1998 or the beginning of 1999, when Dobbs decided to revalue them at $2,950 a share. The Fund had suffered serious losses from some of Dobbs' miscalculations and Dobbs' arbitrary upward valuation of Amercon to $2,950 per share was undoubtedly an attempt to camouflage the losses that would have otherwise come to light in 1998. Dobbs' bad faith upward valuation of Amercon shares increased the value of the Amercon holdings on the books of the Fund from $725,050.00 (at $450.00 per share) to $4,753,109.49 (at $2,950 per share). It also made the

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[2] Dobbs' argument on this Petition that Mehrlich was a standard type of "sore loser" investor is also put to rest by extensive testimony during the hearings that Mehrlich had other comparable hedge fund losses but that he never for a minute thought of suing on them. He sued Dobbs only because of the series of deceptive frauds Dobbs personally perpetrated on Mehrlich.

Fund's Amercon stock holding equal to more than 50% of the Fund's assets as of the end of 1998.

Through 1998, Dobbs sent Mehrlich quarterly statements purporting to reflect the Fund's investment performance. The quarterly report dated January 15, 1999 stated that the Fund's annual performance for 1998 was down 0.96% versus a total return of 28.55% for the S&P 500, *i.e.*, a basic return an unskilled neophyte investor might have attained. On November 12, 1998, Mehrlich, through his advisor Davenport, sent a withdrawal notice to Dobbs requesting that he liquidate Mehrlich's interest in the Fund for cash delivery by January 1, 1999. Dobbs did not honor the redemption request. Instead, on January 19, 1999, Dobbs telephoned Mehrlich and asked Mehrlich to postpone his redemption pending a meeting with Dobbs. Dobbs then met with Mehrlich in California in early February 1999 and attempted to dissuade Mehrlich from redeeming his investment in the Fund. While he discussed the Fund's holdings and performance in that meeting, Dobbs never once mentioned Amercon even though, based on the 1998 year-end value he had ascribed to that stock, Amercon represented well over half of the Fund's assets. Nor did he ever mention his own extraordinary valuation of those shares. Relying on what he had heard from Dobbs at the meeting, Mehrlich did not press his request.

Mehrlich's decision to rely on Dobbs' fraudulently rosy forecasts cost him dearly. The $2,950 per Amercon share valuation that Dobbs originally made in late 1998 or early 1999 was maintained throughout 1999 and 2000. At least six investors in the Fund redeemed their capital in 1999. Because of the high valuation of the Amercon

stock, three of the six investors who redeemed in the course of 1999 received amounts greater than their opening capital. The other three were able to redeem at least 90% of their opening 1999 capital. When Mehrlich later was able to redeem his investment – when the Fund was all but liquidated – he received only $260,631 i.e. 13% of his original investment.

On February 8, 2002, Mehrlich commenced an arbitration proceeding against Dobbs. Despite elaborate dilatory efforts by Dobbs, including an initial long-time default in answering and motions seeking to derail the arbitration prior to its commencement, extensive proceedings on the merits were conducted over the next two years. At first concluded, they were re-opened to accommodate the newly available testimony of John Reeder and another witness. On the eve of the hearing on the about to be resumed hearing on the merits – on December 1, 2003 – Dobbs filed a petition pursuant to Chapter 7 of the Bankruptcy Code. After Mehrlich commenced an action pursuant to 11 U.S.C. § 523(a)(4) seeking a determination that Dobbs' debt to Mehrlich was not dischargeable, the Bankruptcy Court entered an order, modifying the automatic stay so the arbitration proceedings could be completed. On November 17, 2004, after hearing John Reeder and another witness detailing more fraudulent conduct by Dobbs, the Arbitrator, rendered an Award of Arbitrator, awarding the separate sums of $688,125 plus $63,237.50 against Dobbs in favor of Mehrlich.

Accompanying the award, was the Decision of Arbitrator, in which the Arbitrator made findings of fact and concluded that Dobbs had committed common law

fraud against Mehrlich. Mehrlich then moved for summary judgment in the Bankruptcy Court proceeding seeking to have his debt excepted from Dobbs' bankruptcy discharge. On July 5, 2005, the Bankruptcy Court read a decision into the record granting Mehrlich's motion. In his decision, Bankruptcy Judge Drain gave collateral estoppel effect to the fact findings of the Arbitrator – which were in any event not contested – and concluded that the facts warranted excepting the debt to Mehrlich from the bankruptcy discharge. Judge Drain found that the bankruptcy discharge exception applied either under the "actual fraud" or "false pretenses" standard. The District Court affirmed. The Second Circuit Court of Appeals also affirmed in an opinion (the "Second Circuit Opinion") concluding that the case represented nothing more that an unremarkable application of traditional principles of collateral estoppel.

REASONS FOR DENYING THE PETITION

I. Collateral Estoppel Was Properly Applied To An Arbitration Award Made After Extensive Hearings

The Petition should be denied because this case involves nothing more than an unremarkable application of well worn and long standing principles of collateral estoppel to an arbitration award issued by a respected arbitrator after extensive hearings. No matter which way Petitioner tries to dress it up, the error he assigns to the three courts which ruled in favor of Respondent is that they incorrectly applied well-settled law to the facts of this particular case. Petitioner's argument rests on an obvious distortion of both the decision of the

arbitrator and the holdings of all three courts which rejected Petitioner's defenses.

Petitioner, at page 6 of the Petition, has focused on the following sentence taken from the arbitrator's decision:

> "However, at the meeting in early February 1999, Dobbs had a duty to disclose truthfully . . . Dobbs not only had a fiduciary duty to disclose by reason of his status as the person who controlled the Fund' [sic] Manager, but once he voluntarily undertook to explain the 1998 year-end results to Mehrlich, he assumed a duty to speak truthfully and completely."

Petitioner claimed that while the arbitrator correctly articulated the elements necessary to find fraud, this passage reveals that he erroneously created a new duty of disclosure which was not based on any precedent. Dobbs asserted this passage shows that the arbitrator found a new duty to disclose imposed on a "fiduciary". He argued that since the definitions of a fiduciary under state law differ from those found under cases decided under 11 U.S.C. § 523(a)(4) and it's predecessor statutes, collateral estoppel cannot apply. This is the nub of the argument. The courts below properly rejected Dobbs' reasoning because it is premised on a distortion of the arbitrator's use of the English language and because, by applying collateral estoppel to the arbitrator's factual findings only, the argument that he created a new legal standard became irrelevant.

Dobbs claims that "the only way the Arbitrator was able to reach his decision was by combining a breach of fiduciary standard with some elements of fraud." Dobbs is clearly wrong. The distortion of the arbitrator's ruling is revealed from his use of the words "not only". The phrase "not only" signifies more than one. The arbitrator found two independent sources for a duty to disclose. The arbitrator believed one unfulfilled duty to disclose arose from Dobbs' fiduciary status; but he clearly stated that Dobbs also had a duty to disclose, independent of his fiduciary status, "once he voluntarily undertook to explain the 1998 year-end results to Mehrlich".

Whether or not he had a fiduciary status or any fiduciary duties, at the time he spoke to Mehrlich, Dobbs, as the individual who managed the Fund, clearly was knowledgeable as to its performance, prospects and assets. By virtue of Dobbs' position – whether or not he was a fiduciary – Mehrlich had a right to rely on his statements. The arbitrator held that Dobbs, having undertaken to explain the Fund's performance in order to persuade Mehrlich not to withdraw his investment, had an obligation to disclose fully – and he did not. For Dobbs to say that the arbitrator "combined" a breach of fiduciary duty standard with elements of fraud is just wrong and does not comport with the written words of the arbitrator.

Contrary to the argument contained in page 7 of the Petition, neither the Bankruptcy Court nor the District Court agreed with Dobbs' distorted analysis of the arbitrator's words. The Bankruptcy Court specifically stated that the arbitrator himself acknowledged the

reference to a fiduciary duty was "superfluous", (Appendix C to Petition p. 14a,) and the District Court specifically acknowledged the Bankruptcy Court's reference to fiduciary duties as being irrelevant to his decision. (*Id.*, Appendix B to Petition, p. 8a.) Neither the District Court nor the Bankruptcy Court believed the arbitrator's findings rested on Dobbs' status as a fiduciary. Once we remove the reference to a fiduciary from the analysis, there is nothing left to Petitioner's argument on the merits and certainly nothing that would provide a "compelling reason" for this Court to grant the Petition of a writ of certiorari.

The arbitrator's award was made after extensive hearings which were never challenged by the Petitioner. Collateral estoppel was properly applied to avoid the useless repetition of a long and arduous proceeding.

II. None Of The Decisions Of The Three Courts Is In Conflict With This Court's Decision In *Brown v. Felsen*

Petitioner has argued that the Second Circuit's opinion should be reviewed because it is in conflict with the decision of this Court in *Brown v Felsen*, 442 U.S. 127 (1979). Petitioner misunderstands the following sentence in *Brown* which is quoted at page 9 of the Petition.

> "If, in the course of adjudicating a state-law question, a state court should determine *factual issues using standards identical to those of § 17*, then collateral estoppel, in the absence of countervailing statutory policy,

> would bar relitigation of those issues in the bankruptcy court. *Id.*, at 139, note. 10." (footnote omitted)

Petitioner contends that the above passage shows "... *Brown* is precedent that "factual" collateral estoppel may only be utilized by the bankruptcy court in connection with § 523(a)(2)(A) when there is an identity of standards".

The *Brown* court stated that the issue before it was "whether a bankruptcy court may consider evidence extrinsic to the judgment and record of a prior state suit when determining whether a debt previously reduced to a judgment is dischargeable under § 17 of the Bankruptcy Act, 11 U.S.C. § 35". In *Brown*, a creditor obtained a state court judgment upon a stipulation with the debtor after the creditor initiated a lawsuit claiming fraud. Later the debtor attempted to discharge the debt in bankruptcy. When the creditor sought a declaration that the debt was non-dischargeable, the guarantor argued the creditor was estopped by his failure to introduce evidence as to fraud in the state court proceeding. The *Brown* court disagreed, saying that since the bankruptcy case had not yet been commenced, the creditor did not have sufficient incentive to press its fraud claim. Petitioner criticized the Second Circuit Opinion for referring to the quoted statement as *dicta* and not essential to the decision of the *Brown* court, but the Second Circuit's analysis was correct.

Whether or not the statement was *dicta*, Petitioner misconstrues the quoted sentence as requiring that the legal issues decided in the two proceedings must be

identical in order for factual collateral estoppel to apply. The word "standards" in the sentence quoted in *Brown* refers to the standards of proof – not the legal standards, *i.e.*, the elements of the causes of action. This Court addressed that particular subject in *Grogan v Garner*, 498 U.S. 279 (1991). There this Court held that the standard of proof for a finding of non-dischargeability under 11 U.S.C. § 523 is "a preponderance of the evidence" rather than "clear and convincing evidence". The debtor in that case had argued that factual determinations in the state court could not collaterally estop him in the bankruptcy court because the standard – the standard of proof that the *Brown* court was referencing in the quoted sentence – used by the fact finder in the state court was different than that necessary for the bankruptcy finding of non-dischargeability. The Court could not have meant that the legal elements of the causes of action being disputed in the two proceedings needed to be identical in order for factual collateral estoppel to apply. Were that true, estoppel of the identical legal issues would then apply forever obviating the use of factual collateral estoppel.

Dobbs also erroneously criticized the Second Circuit Opinion for citing a venerable decision of Judge Leonard Hand, *Evergreen v Nunan*, 141 F.2d 927 (2d Cir. 1944), arguing that *Brown* overruled the holding of that decision. *Evergreen* held that collateral estoppel has application to factual issues even where the legal issues decided in the prior proceeding are different. The Second Circuit was making the point that even if the arbitrator, in reaching his conclusion that Dobbs had defrauded Mehrlich, had used a new legal standard different than that required by 11 U.S.C. § 523(a)(4), the arbitrator's

factual findings nevertheless provided a basis for collaterally estopping Dobbs as to the facts found. Dobbs' argument was thereby refuted in either one of two ways. Either (i) the reference to a fiduciary by the arbitrator was superfluous and the legal standard he used was the same as required for finding non-dischargeability of the debt under 11 U.S.C. § 523(a)(4), or (ii) the facts found by the arbitrator, which Dobbs was estopped from disputing, were sufficient for the three courts to reach the conclusion under 11 U.S.C. § 523(a)(4) that Dobbs' debt to Mehrlich was non-dischargeable.

Petitioner's mischaracterization of the use of the word "standards" has confused the issue. *Brown* does not conflict with the Second Circuit Opinion.

III. Petitioner's Claim That A Conflict Between Circuits On The Subject Matter Of This Case Requires This Court's Intervention Is Unsubstantiated

Petitioner's assertion that the Second Circuit Opinion conflicts with the opinions of the Eighth Circuit in *Owens v Miller*, 276 F.3d 424 (8th Cir. 2002) and the Fifth Circuit Court of Appeals in *Miller v. J.D. Adams, Inc.* 156 F.3d 598, 602 (5th Cir. 1998), *cert denied*, 526 U.S. 1016 (1999), is premised on Petitioner's mischaracterization of the decisions of the three courts below. As noted in section I above, these courts applied factual collateral estoppel and did not adopt the legal conclusion of the arbitrator. Secondly, even if they had, two of the three courts (the Second Circuit did not address the issue) disagreed with Petitioner's

understanding of the award as being dependent upon a finding that Dobbs was a fiduciary.

The Eighth Circuit's opinion deals with completely different issues than those raised in this case. There the bankruptcy court had concluded that the Securities Exchange Act created a type of agency relationship between an individual broker and principals of his brokerage firm such that the fraud of the broker was attributable to the principals. The bankruptcy court then found the debt created by this attributed fraud to be non-dischargeable under the fraud exception found in 11 U.S.C. § 523(a)(4). The Court of Appeals reversed the district court's affirmation of the bankruptcy court decision.

Dobbs suggests that the refusal to extend 11 U.S.C. § 523(a)(4) to encompass securities fraud is analogous to Mehrlich's attempt to extend the statute to cover the arbitrator's "new" cause of action. The *Owens* decision is simply not analogous. The Eighth Circuit correctly identified the securities law claim as being a legal claim of fraud which had never previously been recognized as being encompassed by the fraud provision of 11 U.S.C. § 523(a)(4). The securities claim was based on a negligent failure to control the fraudulent conduct of an employee where the debtor had no prior knowledge of the fraud. Those facts are in stark contrast to the facts here. The arbitrator found that Dobbs committed garden-variety common law fraud which probably could have been criminally prosecuted. This kind of fraud is routinely seen as falling within 11 U.S.C. § 523(a)(4).

The Fifth Circuit decision, *Miller v. J.D. Adams, Inc.* 156 F.3d 598, 602 (5th Cir. 1998), *cert denied*, 526 U.S. 1016 (1999), cited by Petitioner as being in conflict with the Second Circuit Opinion, turned on the question of whether a jury had made implicit findings necessary to collaterally estop a debtor defending a non-dischargeability proceeding. In that case, judgment was entered in state court against a debtor in a suit by a former employer. The jury found that the debtor misappropriated proprietary information or made an improper use of the trade secrets but also found the debtor had not acted with "malice meaning ill will, spite, evil motive, or flagrant disregard for the rights of others." Appellant sought to discharge the judgment in bankruptcy proceedings but the bankruptcy court held that the judgment was not a dischargeable debt under 11 U.S.C. § 523(a)(4). The district court affirmed, but the Fifth Circuit reversed. The Fifth Circuit held that the jury's finding that appellant acted wrongfully in misappropriating or misusing the proprietary information did not include a finding of fraudulent intent, an element necessary under the bankruptcy statute.

The Fifth Circuit case, which turned on the absence of sufficient factual findings to estop the debtor from defending a non-dischargeability action, is merely an illustration of classic principles of collateral estoppel. The decision does not conflict with the Second Circuit Opinion here.

IV. Petitioner's Claim That Review By This Court Is Warranted Because The Second Circuit Opinion Conflicts With Other Second Circuit Decisions Is Preposterous

Petitioner's claim that the Second Circuit Opinion conflicts with *Ball v. A-O-Smith Corp.*, 451 F.3d 66 (2d Cir. 2006), a decision cited approvingly in the Second Circuit Opinion, is preposterous. (Petitioner unsuccessfully sought *en banc* review of the Second Circuit Opinion and Hon. Reena Raggi was a member of the panel in both cases where unanimous decisions were rendered.) In *Ball*, a Louisiana District Judge awarded sanctions against a lawyer, who attempted to discharge that obligation in bankruptcy. In non-dischargeability proceedings commenced under 11 U.S.C. § 523 both the debtor and creditor argued the sanctions award collaterally estopped the other from succeeding. Both lower courts and the Second Circuit Court of Appeals concluded that standards for awarding sanctions in the Fifth Circuit necessarily encompassed findings of malicious and willful injury which are a prerequisite to non-dischargeability under 11 U.S.C. § 523(a)(6). Petitioner asserts this case supports his contention that in order for factual collateral estoppel to apply, both proceedings must have identical standards. Here, in this context, Petitioner uses the phrase "identical standards" to mean that the issues decided (factual or otherwise) have to be the same. This just states a basic prerequisite to the application of collateral estoppel. In order for preclusion to apply there has to be an identity of issues. That is what governed the *Ball* decision: 11 U.S.C. § 523(a)(6) requires a finding of willful and malicious intent and the court was determining whether that issue

had already been decided implicitly in the Louisiana court's award of sanctions.

The case here is completely different. There is no controversy here as to whether the factual issues necessary for non-dischargeability were found by the arbitrator; all of the facts found by the bankruptcy court here were expressly found by the arbitrator. The bankruptcy court here used case law precedent and the arbitrator's explicit findings to conclude that Dobbs had committed fraud recognized as non-dischargeable under 11 U.S.C. § 523(a)(4) and its predecessors.

Neither the *Ball* decision nor any other Second Circuit law is in conflict with the Second Circuit Opinion in any way.

CONCLUSION

Petitioner has not established any compelling reason for this Court to grant the Petition. Therefore, Respondent respectfully requests that the Petition be denied.

Respectfully submitted,

NORMAN SOLOVAY
HARTMAN & CRAVEN, LLP
488 Madison Ave, 16th Floor
New York, NY 10022
(212) 754- 6915

ISAAC NUTOVIC
Counsel of Record
NUTOVIC & ASSOCIATES
488 Madison Ave, 16th Floor
New York, NY 10022
(212) 421-9100

Attorneys for Respondent

APPENDIX

APPENDIX A — SWORN DECLARATION OF JOHN REEDER DATED AUGUST 12, 2004

AMERICAN ARBITRATION ASSOCIATION
NEW YORK REGIONAL OFFICE

Case No. 13168004162

RICHARD W. MEHRLICH,

Claimant,

-against-

BILL D. DOBBS, JR. and
FORMULA FUND MANAGEMENT, LLC,

Respondents.

DECLARATION

JOHN REEDER, under penalties of perjury, affirms as follows:

1. I make this Declaration in response to a subpoena requiring my appearance at a hearing to state relevant facts about my knowledge of Bill D. Dobbs, Jr., ("Bill") his fund management company, "Formula Fund Management," and one of his two hedge funds, Formula Fund, LLC.

2. I understand that, if ordered by the Arbitrator, I must appear in person as a witness at the hearing, which I understand has been scheduled for August 20, 2004. In lieu of a personal appearance, I make this Declaration

with the hope that it will adequately provide information needed by both parties to sort out their differences. If my personal appearance becomes necessary for cross-examination, my brother, Joe Reeder, who is a lawyer, can advise me during the cross-examination via telephone from his office in Washington, D.C.

3. Bill and I met at Columbia Business School where we became close friends. We both graduated with MBAs in 1994. Following my graduation, I went to work for Rocker Partners, a hedge fund oriented investment management company. In 1997, after the formation of Bill's two hedge funds and management company, he asked me and another good friend of ours, Michael J. Gaston (our classmate and Bill's roommate at Columbia Business School) to serve as two of the three required directors of the newer and smaller of the two funds, Formula Offshore Investment Fund, incorporated in the Cayman Islands August 6, 1997. We both accepted this invitation.

4. Beginning 1998, I ended my employment with Rocker. While looking for new employment, Bill offered me (sometime in the fourth quarter of 1998) the use of office space at his Fund's premises. Then, sometime in that same fourth quarter, Bill and I discussed the possibility of me helping the marketing effort of his two Funds following the departure of Candice Howard, who until the third or fourth quarter of 1998, formally held the job of Marketing Director at Formula Fund Management. By December 1998, I began coming to Bill's offices on a regular basis for approximately 2 hours

a day. While I never received a salary, Bill offered to pay me a commission for any money I could raise for either fund. However, I never raised any money. For helping him with promotional material, Bill did pay me twice: $1,500 in February 1999 and $2,000 in April 1999.

5. In January 1999, at Bill's invitation, I accompanied him to California to attend meetings with several investors in Formula Fund, LLC. One particular lunch meeting was with Richard and Beverly Mehrlich, where I watched Bill persuade them to stay invested in the fund despite a negative 1998 performance. Although I didn't know it at the time, I later learned that a potentially significant factor in maintaining a comfortable level of liquidity in Bill's onshore fund was riding on his ability to persuade the Mehrlichs to rescind their request for redemption of their $2,000,000 investment.

6. My recollection is that the lunch meeting, which was also attended by the Mehrlichs' stockbroker, John Davenport, lasted nearly two hours. While I do not recall everything said and therefore cannot give a comprehensive description of all the things discussed by Bill at that particular meeting, some things do stand-out in my mind, including: Bill offered a "hurdle-rate," which essentially meant that no performance fee (20% of net capital appreciation) would be levied unless it beat 8%. As part of the discussion, Bill acknowledged that he had made a significant misjudgment as a portfolio manager in 1998 that was the cause of a double-digit loss (approximately 20%, I recall) of the Fund's value in the

fourth quarter 1998. He described persuasively how he had since devised a "portfolio allocation matrix" that would assure that such a mistake would not likely occur again. Bill explained that the matrix would flag any over-concentration or under-diversification in any sector, capitalization size, and a number of other aspects of securities. Bill's presentation echoed his Year-End 1998 Letter to Investors:

> *We have taken steps to safeguard against that kind of volatility.*
>
> *Among other things, we (i) added two strong fundamental analysts, (ii) established a matrix weighting policy for sector and capitalization, and (iii) adopted a price-delta containment policy.*

7. I recall from the lunch meeting that Beverly Mehrlich opposed continuing with the Fund, but Bill's overall presentation, including discussions about his investment style and some specific stocks, captured Richard's interest. In all of his January 1999 visits with investors on the West Coast, I observed Bill presenting himself as star security analyst, but one that needed some seasoning in portfolio management. He vowed that the reported drop in October was a onetime event. Bill did not disclose ownership of any private holding.

8. While I was doing some analytic work on the portfolios of both funds sometime in March or April 1999, Bill's administrative assistant, Janet Faleski, brought to

my attention, without Bill's knowledge, the fact that, during the fourth quarter of 1998, Bill had significantly raised (marked-up) the value of a privately held company in both funds on the heels of a significant loss of approximately 55% from a short sale of a group of stocks in the semiconductor sector. The private equity was named Amercon International Incorporated, a Delaware corporation, founded by Bill January 12, 1998. Bill served as its founding Chairman through September 1999. Bill resigned as Director sometime in 2001. Both of Bill's funds and he personally owned common stock in Amercon. My unearthing of Bill's actions raised several concerns in my mind. One, without the marking up of Amercon, Bill's performance in the fourth quarter would have to be viewed as much worse than he was telling investors (*i.e.*, down 55% rather than 20%). Two, the timing of the markup, regardless of Bill's justification, would, at best, create the perception that he was manipulating the value of both funds. Three, the over-weighting of Amercon was the result of the mark-up, and as I later learned, to some extent, also the result of some redemptions. Four, the self-imposed high weighting of Americon intensified the duty to make certain that the valuation was accurate and justified; because now, the performance of both funds relied heavily on Bill's valuation of Amercon. Five, if the valuation were in any way arbitrary, fees and redemptions would be inaccurate and overstated. For example, if any investors redeemed from an overvalued fund, the earlier redeemers would be getting a better deal than the later redeemers. Put another way, earlier redeemers would be walking away with money that belonged to investors staying in the fund.

Appendix A

9. As mentioned in 8 above, I learned about the 55% three-week loss and subsequent mark-up of Amercon without Bill telling me. I later found some documentation in the prime brokerage online records maintained by Banc of America Securities ("BOFA," fka NationsBanc Montgomery Securities, the custodian for both of Bill's funds). In Formula Fund, Bill increased the value of 1,722 shares of Amercon from an average cost of $450 a share to nearly $3000 a share in the fourth quarter of 1998. Simultaneously, in Formula Offshore, he also raised the valuations of 183 shares from $1,825 to about $3,000. The specific records where this information was stored in BOFA's client database are, "Client Position Summary by Asset Class" and "Working Appraisal by Asset Class." I strongly protested to Bill that this action was a poor decision. Bill told me that that the mark-up was proper because of an offering of Amercon common stock and reasonable expectations of its performance. I learned from Bill that he did, in fact, do an offering of 549 shares of Amercon stock in October 1998 at $1,825. One of my many objections was that the mark-up far exceeded the recent offering price, and the offering was small. So, the price paid might not accurately represent the value of Amercon. Moreover, I wondered how much subjectivity contributed to the reasonable expectations. Bill never did share with me his methodology. But he did claim that adjusting valuations of private holdings is a common practice of hedge funds.

10. I told Bill this was not the case. I explained to Bill that my experience was that when hedge funds hold illiquid securities, they do not let the portfolio weighting

become significant and, therefore, do not feel the need to even care about raising the valuation. I told him that, if maintaining a low weighting of illiquid securities is faithfully practiced, then he probably could justify not disclosing the holdings to investors because their impact would be relatively immaterial; otherwise, disclosure would be important.

11. I also insisted that, given the weight of Amercon in both portfolios, practicing a more conservative valuation was less risky, ergo more prudent for many reasons, including the five mentioned under 8, above. At this point, while I did not agree with Bill's decisions, I felt that he was trying his utmost to recover from an unfortunate systemic market event by trying to (a) instill calm and confidence among investors, (b) prevent a "run-on-the-bank," and (c) preserve pricing power of Amercon by not disclosing its holding and particulars in both funds. While some theoretical arguments can be made that secrecy of hedge fund holdings (particularly private equity) may benefit hedge fund members, the problem is that private equity must be properly valued, and there is not complete agreement on how to do that. In any event, as I argued to Bill, Amercon's unusual weight in both portfolios called for conservative valuation and complete disclosure. Proper valuation of an illiquid security, such as Amercon, would not typically be a critical matter for a fund manager if it were only a small part of the portfolio. Regardless of any latitude Bill argued that he had under any written agreement, my view, as I told him, was that members of both funds had every reason to assume that he was primarily managing long and short positions in liquid equity (tradable stock).

Appendix A

Everything Bill ever said or wrote about the funds should have made its members comfortable in assuming this. When Bill would feature a stock in a Quarterly Newsletter, as he always did, for example, one could assume that it could have a significant impact on the portfolio. But, he never mentioned Amercon, one of the top two positions. He never mentioned anything about a private equity. And, as I learned recently, by reading testimony from other lawsuits against Bill, he did not volunteer the fact that Amercon was essentially his own company. As a Managing artner for Formula Fund Management, LP, Bill might argue today that he could have bet on the Super Bowl and been within his **m andate of the fund subscription docum ents**[1] As an example of Bill liberally exercising his latitude, in September 1999, I noticed a cash loan from Formula Fund to Amercon at a favorable interest rate. While I do not recall the amount, I remember asking Bill about it — whether it was prudent for a fund to make a loan to a privately held equity in its portfolio. Having followed Amercon, I recently learned that this loan was converted to equity in 2001.

12. The hedge fund industry commonly refers to a "cowboy" as one who makes fast or large or risky bets. In terms of "large" for a hedge fund, I would consider a

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1. The Super Bowl logic quote was made by an attorney for Conrad P. Seghers, Managing Partner for Dallas based Integral Investment Management whose funds, among other things, made investments in their own software company without disclosing it to the Limited Partners. Art Institute of Chicago v. Integral Investment.

10% position a large bet. I would consider a 30% position a huge bet; risky, too. One would be well-advised to not have a 30% position with other people's money without their prior knowledge. Between Amercon and Coastcast, Bill was way beyond that, up in the 90% range. And even long after he got into that situation (two or three years later), he not only didn't tell his investors, he gave no reason to expect anything was awry.

13. Another point I made to Bill (and separately, his wife, Jennifer Anne Wallace) was that, if for nothing else, raising the valuations of his own company,[2] Amercon, on the heels of a stunning three-week loss was a bad idea because of the potential to create perception problems.

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2. Bill regarded Amercon as his own company in a perceptual sense. He had talked about the possibility and vision of someday turning it into a Berkshire Hathaway value oriented holding company for investments. Acting on information from an acquaintance at then Dillon Read, Bill founded Amercon after a failed attempt to purchase a manufacturing unit of Chromalloy, a subsidiary of Sequa Corporation. After careful due diligence, Bill recruited the key management from Chromalloy, who were eager to join Bill in a startup company. Bill raised the needed seed money and handpicked the Directors to assure that Amercon had a strong array of specific skill sets. Through 1999, from what I was able to observe, and to the ire of his only salaried employee, Don Bilson (Don), he devoted the largest portion of his time to its struggling affairs. Bill was constantly on the phone with Amercon; and, when it needed an emergency infusion of cash to survive, as it often did, Bill would make the calls. Throughout 1999 (through September 15), all Amercon conference calls with Directors were organized, scheduled, and made through Bill's office.

Both he and his wife, Jennifer, encouraged me to work harder to raise money to help ease what was a liquidity squeeze, which occurs when more liquid or marketable securities are sold to meet redemption requests. A liquidity squeeze can leave later redeemers and those who remain invested in a fund stuck with a disproportionate percentage of a fund's illiquid securities that might have to be marked down to enable an unplanned sale. In other words, early redeemers get a better deal.

14. My brother, Joe, is one of the founding directors of Amercon. In 1998, Bill had aggressively recruited Joe to serve as a Director of Amercon, telling both of us how helpful it would be to have on the Board someone with my brother's experience, knowledge, and connections to the aerospace industry. Joe had become a partner in a major national law firm in Washington DC after serving as the 14th Undersecretary of the Army and Chairman of the Panama Canal Commission's Board of Directors (1993-97). In asking him to serve as a Director of Amercon, Bill had specifically assured him that no investment in Amercon was required or contemplated from him. At some point thereafter, however, Bill began urging Joe to make such an investment. Although Joe and I were surprised by this turnabout, Joe ultimately did make investments of $500,000. Joe had relied on advice from me, and, in turn, I unfortunately relied heavily on Bill's optimistic predictions and evaluations.

15. Sometime, in the first quarter of 1999, Bill began to lean heavily on Joe to also make an investment in

Formula Fund. Joe did not initially reject the request because he at first thought it might be a good way to diversify his holdings. Even though he was an Amercon Director; my brother had no idea that Amercon and Coastcast shares constituted a substantial portion of Formula Fund — eventually some 95%. At that time, I didn't comprehend it fully myself, partly because I was unaware (a) of Amercon's high weighting in Formula Fund (some 55%), (b) of the substantial 1998 redemptions, and (c) that Coastcast had very low liquidity in the stock market. I was also unaware of the substantial loss during a three-week period in October 1998 due to Formula Fund's selling short several stocks in the semiconductor sector. The October loss was partially camouflaged by the above-mentioned subsequent markup of Amercon, which I also did not know about until later. However, I ultimately became aware of these facts — but only after my conversation with Janet Faleski in March or April 1999.

16. When I cautioned Joe (probably in the second quarter of 1999) that Formula Fund was highly concentrated with Amercon common stock, he was furious because Bill was doing something that we both considered to be an oblique attempt to double-expose Joe to Amercon. At this point, nearly all its Directors and management considered Amercon to be high-risk and under deep distress.

17. After repeatedly being urged by Bill to invest more in Amercon and Formula Fund, Joe phoned me in September 1999 to accompany him to the home of

Amercon in Harrisburg, Pennsylvania, for meetings with its Directors and management to see if we could understand its apparent cash-flow problems. Joe and I visited twice: the weekends of September 4th and 11th 1999. Bill did not attend either meeting.

18. Although my final face-off and separation from Bill did not take place until September 15, 1999, I had a number of unpleasant discussions with both him and his wife, Jennifer, throughout 1999 when I tried to persuade them to "let some air out of the tires" (i.e., slowly and systematically lower the value of Amercon) and to be transparent with investors about Amercon.

19. I told Bill on several occasions that he could be more transparent by disclosing to investors what was happening to Amercon and by either (a) divesting his personal holdings in Amercon or (b) drawing up a plan to liquidate the Funds or (c) preferably both. While Bill vigorously defended his decision to significantly mark-up the value of Amercon in 1998, my initial criticism was that any coincidence in timing — and, I had great doubts about Bill's assertion that there was a coincidence — allowed the possibility for investors to *perceive* that valuations were being manipulated. Bill and I clashed over that and other potential perception problems, including one that could arise from the fact that he personally owned an interest in Amercon. There were other potential problems. One was that the Funds would need to stand-up well in an independent audit — which, I believed it could not.

20. My face-to-face discussions with Jennifer on these issues had come about because the remodeling of the offices of her employer, Oak Hill Partners, Inc., permitted her to sublet a spare office from Formula Fund Management to use for her office from mid to late 1999. While there, she assisted Bill with the operation of his Funds on a part-time basis, helping turnout promotional materials, including authoring and editing letters to investors.

21. By the time Jennifer had moved into Bill's offices, the situation at Amercon had clearly become critical. On a number of occasions, I tried to engage them — together and separately — in discussions of remedial steps that I thought were essential. Among the things that I and others pressed Bill to do were to make full disclosure to the Funds' investors (which I argued he had moral obligation to do) of their extensive holdings in Amercon and of Amercon's increasingly precarious situation; and to lower the value of Amercon shares to a more realistic level. I specifically referred to the write-down proposal as "letting the air out of tires." I also recommended that he eliminate the possibility for any perception of a conflict involved in his personal ownership of Amercon shares either by divestiture of his personal Amercon holdings or, alternatively, by working out an equitable plan of dissolution for the Funds. I recall specifically telling Bill that if he did not take such steps he might be tempted to escape from the situation by an action I described as a "Hail Mary Pass," a high-risk, high-return maneuver. In a discussion on September 15, 1999, I recall Bill pointing out that if

Coastcast hit a certain price, the Fund would show a substantial profit for the year. I remember thinking that Bill's fixation on Coastcast as a salvation was precisely what I had meant by "Hail Mary Pass." I also recall pointing out the inherent conflict between his personal stake in Amercon and the stakes owned by both funds. I warned him that that he might be tempted to try to preserve his personal stake in Amercon at the Funds' expense. He argued that the self-interest from his personal stake in Amercon was in the best interest of both funds. He also reminded me that his personal He lectured me that his personal stake in Amercon was considerably smaller than those owned by either fund. I never agreed with either argument. I told him that, even if one were to accept it as valid, the situation could trigger a perception by investors that Bill was using one of the least regulated vehicles in finance, the hedge fund, for personal gain in Amercon. I told Bill, in that September 15th meeting (1999), that if there was a possibility that both funds could fail, for whatever reason, and, if Amercon were to survive to the personal benefit of Bill, that would be a spectacular illustration of why it's critical to carefully avoid even the appearance of such a conflict of interest. Regarding Bill's other argument (that his relative smaller personal interest negated any appearance of conflict), I told him that his small interest makes the scenario all the more egregious. In other words, if two funds (that were highly composed of Amercon) failed while even a mere survival of Amercon benefited a small personal interest owned by Bill, investors may see an outrageous example of a "tail-wagging-two-dogs-to-death," Bill's interest in Amercon being the tail, the funds being the two dogs.

22. My discussions about these subjects with Jennifer were strained and brief. Broaching the subject was awkward, I believe, because we, after all, were friends; and Jennifer was pregnant with their first child, a beautiful daughter born October 10, 1999. Starting in late spring or early summer 1999, she, along with Bill, emphatically blamed Amercon's problems on the fact that Amercon executives misled both of them about their level of competence. They both felt that they had been "had," by inept management. By now, I was witnessing logic-whiplash between two extremes. On one hand, Bill vigorously defended the mark-up of Amercon in both portfolios; while, simultaneously on the other hand, both Bill and Jennifer were conspicuously furious about a complete breakdown in financial control at Amercon. I thought it was particularly unfair to claim ignorance and to blame Amercon management when Bill was both its Founder and Chairman and both he and Jennifer held MBAs in finance from Columbia.

23. Bill had relied on the Amercon management which he had selected to run the company when in fact it was lacking the management skills apropos for a manufacturing startup. Bill once expressed surprise and disappointment to me and others, in assigning blame, when he discovered that Amercon management did not even realize that they had been producing and selling products at a loss. I later learned that Amercon management was equally disappointed with Bill. Management initially harbored a very high degree of confidence in and reliance on Bill. Few people were closer to the business activities of Amercon than Bill. He was

its founder, Chairman, and fundraiser. From time to time, he accepted advice from Jenny, who, like Bill, holds an MBA from Columbia and had been a star management consultant at McKinsey. Jenny helped analyze the accounting problems in an attempt to understand the cash flow problems at Amercon; and presumably, this advice was passed on to management by Bill.

24. In a brief discussion in September 1999, Jennifer told me that my inaction in marketing (raising money by getting new investors) was part of the cause for liquidity problems of both funds. She specifically said, "If you were doing your job of raising money, Bill would not have a liquidity or imbalanced asset allocation problem." It was then that I fully realized that my concerns and objections were being ignored. I had refused to raise any money unless either (a) the funds were properly balanced and accurately valued or, at a minimum, (b) Bill made a complete disclosure to existing and potential investors.

25. At the request of my brother, Joe, from September 1999 to present, I have advised him with his Directorship at Amercon. This practice began after I resigned as a Director of Formula Offshore and after I severed my personal and professional relationship with Bill.

26. During mid to late 1999, I noticed that serious problems had begun to manifest themselves at Amercon, including strained relations (sharp exchanges) between Bill and other Amercon investor-directors. I was present

at an emergency Amercon Board Meeting that produced an email by Jon Vannini dated September 16, 1999, addressed to my brother (a copy of which, marked as Claimant's Exhibit 27, has again been shown to me). Bill was, of course invited to this meeting. He had been advised that new steps to try to save Amercon would be taken. Bill, instead, chose not to attend the meeting and instead, announced that he was staying in New York to play golf, which annoyed management and his fellow directors.

27. Shortly thereafter (still in 1999), Bill was removed as Chairman of Amercon and a new one was elected. I am not sure of the specific reason(s) for his removal, but my impression was that, among other things, Amercon management and board members recognized potential conflicts of interest between his funds and his role as Chairman. I also sensed that management and most of the board members by then intensely disliked him. When I accompanied Joe to meet with management on September 4, 1999, I heard a couple of executives refer to him as the "screamer" because of his approach to problem-solving, namely loudly berating management while laying blame for the failures at Amercon on their incompetence. Bill knew two of the Directors — Philip F. Friedrich and Paul, his brother — long before forming Amercon. Bill had once been engaged to marry Phil's daughter and remained friendly with Phil and Paul even after it had been called off. Phil participated in the September 1999 meetings via telephone. Phil was highly involved in helping save Amercon. At one of the September meetings, I

remember hearing my brother, Joe, bitterly complain to Phil about Bill having the nerve to ask him to invest Formula Fund, given the dire situation at Amercon and high weighting of it in the Fund. While Joe was saying this, he apparently did not realize that he had touched a nerve — both Phil and Paul were investors not only in Amercon, but also in Formula Fund. Phil angrily said, "Bill has screwed my brother and me. I am not a wealthy guy. It took me a lifetime to save what I have; and I've just lost a big percent of it." It is my understanding, however, that Bill subsequently made peace with Phil and Paul by redeeming their investments in Formula Fund.

28. At a September 1999 meeting, Jon Vannini was elected Chairman of Amercon, replacing Bill. Jon Vannini served as Chairman until sometime in 2000. Amercon's current CEO, Alfred P. Matarese, has been its Chairman since November 9, 2000. Jon was an original investor in and Director of Amercon and, incidentally, he was also an original investor in Formula Fund. However, the initial key steps that were ultimately taken to salvage Amercon in 1999, including the decision to bring in a new chief executive and do a thorough housecleaning, were put into motion by my brother, Joe.

29. Bill's personal ownership of Amercon common stock is subject to filing for Bankruptcy, Chapter 7, December 1, 2003.[3] But Bill still participates in Amercon

3. Billy D. Dobbs, Jr., NY Bankruptcy Court, Southern Dist. Case No. 03-17622, filed December 1, 2003. Schatten's adversary filing against Dobbs' Bankruptcy — Case No. 04-2781.

Board meetings as representative for Formula Fund, LLC, which currently owns an equity interest of 11.4%. Formula Offshore Investment Fund owns an equity interest of 1.4% of Amercon, but is now in the throes of a voluntary windup. Until Bill filed for protection under bankruptcy, he personally also owned an equity interest in Amercon.

30. For Formula Offshore Investment Fund, the only meetings Michael Gaston and I ever held as Directors were telephone conversations complaining, among other things, that Bill had not advised us of any goings-on, other than to provide copies of the Quarterly and Annual Letters. In addition to me voicing the aforementioned criticisms to Bill, Michael once scolded Bill (sometime in 1998) over not being advised of anything at Formula Offshore and that he felt he was being taken advantage of as a friend. He threatened to resign as Director if Bill did not schedule official Board Meetings and provide him with concise, detailed presentations that were apropos for Directors. Michael and I submitted our resignations as Directors in writing to Formula Offshore and Citco Fund Services, he in August 1999 and I on September 14, 1999. CFS Company, Ltd., an affiliate service company of Citco, served as the third Director of Formula Offshore. At least one Director was required to be domiciled in the Cayman Islands.

31. Citco, based in the Cayman Islands with offices in New York, was the Administrator for Formula Offshore Investment Fund. No one from Citco contacted either of us to ask why we had resigned. To my

knowledge, the two Director vacancies were never filled. Neither Bill nor Citco nor CFS ever disclosed to investors in Formula Offshore Investment Fund, existing or prospective, that neither Michael nor I were any longer on the Board.

32. On September 15, 1999, Bill informed me that he had accepted an offer from Howard P. Berkowitz (his former employer) for Formula Fund Management to manage money for HPB Associates. The agreement included salaries and, I think medical benefits for himself and for his fulltime equity analyst, Don and, he said, for me. Don accepted and remained employed with Formula Fund Management. I declined the offer.

33. Amercon has sustained operating losses — from its inception (January 1998) through today — totaling nearly $13 million. The company has struggled to maintain operations since inception. Amercon is still privately held with an ownership split of 53% by original venture capitalists — (11.4% by Formula Fund) and 47% by United Technologies. Amercon has sought new ownership to infuse working capital and help fund growth for the past three years without success. Amercon sees modest increases in volume but still substantially lower levels by 45% under 2001.

34. Sometime in 2002, Patrick Agemian of Citco phoned me to discuss Formula Offshore Investment Fund because of a lawsuit. I since have spoke a few times with Patrick. Citco (or its affiliate) has, until the voluntary liquidation, served as Fund Administrator of

Formula Offshore. In one of our conversations, Patrick told me that if Bill owned a personal stake in a private security that was also owned by the Fund, it was not only conflict of interest, but also a violation of Citco's written agreement with Bill.

35. As for Formula Offshore Investment Fund, in November 2002, Bill had phoned Michael Gaston in London to say that he wanted to come over to have some documents signed. Bill needed to transfer the 100 Management Shares (that were originally issued to Michael on August 6, 1997) to a third party of Bill's choosing, which would empower Bill in some way to overcome a dispute with Citco over the voluntary windup and liquidation of Formula Offshore. Michael was unaware that he had been assigned those shares. In January 2003, Michael told Bill that he was very unhappy to be caught in the middle of a dispute between Bill and Citco three years after he thought that any involvement that he had with Formula Offshore ended. Michael ultimately transferred those share to CFS Company, Ltd., an affiliate of Citco, on March 19, 2003, rather than to Bill's designee.

36. Effective April 23, 2003, Ernst & Young, Ltd, Cayman Islands, became the voluntary liquidator of Formula Offshore. The individuals serving as co-liquidators are Richard E.L. Fogerty and Jim Cleaver. They succeed CFS as Fund Administrator and Director. They can be reached by calling Mark McDonald in the Cayman Islands at 345-814-4004. They are currently searching for the stock certificates for Amercon and are

researching whether selling them is subject to preemptive restrictions such as Right of First Refusal by existing investors.

37. The years 1998 and 1999 were very turbulent years in the financial markets. Many hedge funds, using a variety of risk control techniques failed during that time. Given the market and sector volatility of those two years, I am not sure if Bill's so-called "portfolio allocation matrix diversification model" that he promised to the Mehrlich's would have been successful even if it could have been faithfully executed — which, of course — it never was. My primary gripe with Bill during 1999 was over the lack of transparency in the presentation of Amercon to Formula Fund investors, both in regard to Amercon's financial condition and its weight in both portfolios. I felt that, whatever Bill's justifications for Amercon's valuation were, the timing of the re-valuation could create the perception of a self serving choice, since it was so much in Bill's interest to reduce the size of his apparent losses during the hysteria that gripped the financial world in the Fall of 1998. Ultimately, as my concerns were not addressed, I concluded that I had no choice but to resign from my directorship of Formula Offshore and to sever my relationship with Bill.

s/ John Reeder
John Reeder

August 12, 2004

87

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No. 07-801

IN THE

Supreme Court of the United States

BILLY D. DOBBS JR.,

Petitioner,

v.

RICHARD MEHRLICH,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF

JOSEPH J. HASPEL
THE LAW OFFICES OF
DAVID CARLEBACH
40 Exchange Place
New York, New York 10005
(212) 785-3041

Attorneys for Petitioner

214490

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

TABLE OF CONTENTS

Page

TABLE OF CITED AUTHORITIES ii

INTRODUCTION 1

REASONS FOR GRANTING THE PETITION . 2

I. CONTRARY TO RESPONDENT'S ASSERTION, *BROWN* DOES REQUIRE THAT A FACTUAL FINDING OF FRAUD BE BASED ON THE EXACT ELEMENTS OF FRAUD UNDER SECTION 523(a)(2)(A) IN ORDER FOR THE PRIOR FINDING TO BE GIVEN COLLATERAL ESTOPPEL EFFECT FOR NON-DISCHARGEABILITY. 2

II. CONTRARY TO THE RESPONDENT'S ARGUMENT, THE SECOND CIRCUIT'S SUMMARY ORDER CONFLICTS WITH THE EIGHTH AND FIFTH CIRCUITS SINCE THE ARBITRATOR USED A STANDARD FOR FRAUD WHICH VARIED FROM THE EXACT STANDARD UNDER SECTION 523(a)(2)(A). 3

III. CONTRARY TO THE RESPONDENT'S CONTENTION, THE SECOND CIRCUIT'S SUMMARY ORDER IS IN CONFLICT WITH ITS PRIOR HOLDING IN *BALL* 6

CONCLUSION 8

TABLE OF CITED AUTHORITIES

Page

Cases:

Ball v. A.O. Smith Corp.,
451 F.3d 66 (2d Cir. 2006) 6, 7

Brown v. Felsen,
442 U.S. 127 (1979) 1, 2, 3

Davis v. Aetna Acceptance Co.,
293 U.S. 328, 55 S. Ct. 151,
79 L. Ed. 393 (1934) 5

Federal Insurance Company v. Gilson,
250 B.R. 226 (Bnkr. E.D. VA. 2000) 5, 6

Miller v. J.D. Abrams, Inc., (Matter of Miller),
156 F.3d 598 (5th Cir., 1998), *cert. denied*,
526 U.S. 1016, 119 S. Ct. 1249, 143 L. Ed. 2d
347 (1999) 4, 5, 6

Owens v. Miller,
276 F.3d 424 (8th Cir. 2002) 3, 4

Cited Authorities

Page

Statutes

11 U.S.C. § 523(a)(2)(A) ..... *passim*

11 U.S.C. § 523(a)(4) 5

11 U.S.C. § 523(a)(6) 7

28 U.S.C. § 1927 7

Other Authority

4 COLLIER ON BANKRUPTCY, P 523.10[1][C] (15th ed. rev., 1998) 5

INTRODUCTION

The Respondent argues that there exists no "compelling reason" to grant the Petition. Specifically, the Respondent asserts that the Bankruptcy Court properly applied collateral estoppel to the arbitration proceeding, the lower court's decisions do not conflict with this Court's decision in *Brown v. Felsen*, 442 U.S. 127 (1979), there is no conflict between the Circuits, and that the Second Circuit's Summary Order is not in conflict with a prior Second Circuit decision.

The Respondent, in interpreting the caselaw cited in the Petition, fails to apprehend that collateral estoppel can only be applied under Section 523(a)(2)(A) of the Bankruptcy Code ("Section 523(a)(2)(A)") when the prior proceeding's finding of fraud applied the exact standard for fraud under Section 523(a)(2)(A). Therefore, if the standard employed in the prior proceeding's finding of fraud contained any variance than the standard required under Section 523(a)(2)(A), collateral estoppel cannot be used to find non-dischargeability. Thus, in this case, the Arbitrator's variance from the Section 523(a)(2)(A) standard of fraud, by employing a different standard which also considers the Petitioner's position as a fiduciary to Respondent, cannot be used for Section 523(a)(2)(A) utilizing the doctrine of collateral estoppel.

REASONS FOR GRANTING THE PETITION

I. CONTRARY TO RESPONDENT'S ASSERTION, *BROWN* DOES REQUIRE THAT A FACTUAL FINDING OF FRAUD BE BASED ON THE EXACT ELEMENTS OF FRAUD UNDER SECTION 523(a)(2)(A) IN ORDER FOR THE PRIOR FINDING TO BE GIVEN COLLATERAL ESTOPPEL EFFECT FOR NON-DISCHARGE-ABILITY.

As set forth in the Petition, the Arbitrator based his finding of fraud, not on the classic elements of fraud, which are essentially the same as those under Section 523(a)(2)(A), but also due to the Petitioner's position as a fiduciary. Thus, the Bankruptcy Court, under *Brown*, could not have used the Arbitrator's finding of fraud, via collateral estoppel, as a basis for non-dischargeability, since being a fiduciary is not an element under Section 523(a)(2)(A). As this Court set forth in *Brown*, the factual findings must be made using a standard *identical* to those under 523(a)(2)(A). Since, under Section 523(a)(2)(A), whether the Petitioner was a fiduciary is not a factor, the Bankruptcy Court should not have given the Arbitrator's finding of fraud collateral estoppel effect.

The Respondent argues, on page 11 of his Brief in Opposition (the "Opposition"), that the legal standard *Brown* was speaking of was the burden of proof, and not the elements of fraud under 23(a)(2)(A). That is clearly inaccurate. In point of fact, the Court in *Brown* never discussed the burden of proof, but was indeed concerned only with the elements of a determination of fraud in a

cause of action brought in state court. The Court in *Brown* stated that the legal standard used in the state proceeding must be the same as the legal standard the Bankruptcy Court would have used. As set forth in the Petition, the elements of fraud under Section 523(a)(2)(A) are essentially the same as that of common law fraud, which does *not* include consideration of whether the Petitioner was a fiduciary. Thus, in this case, where the Arbitrator factored in the Petitioner's position and special duties and responsibilities as a fiduciary in order to make a finding of fraud, essentially acknowledging that but for Petitioners special status as a fiduciary no finding of fraud could have been made, such a finding of fraud cannot be given collateral estoppel effect.

II. CONTRARY TO THE RESPONDENT'S ARGUMENT, THE SECOND CIRCUIT'S SUMMARY ORDER CONFLICTS WITH THE EIGHTH AND FIFTH CIRCUITS SINCE THE ARBITRATOR USED A STANDARD FOR FRAUD WHICH VARIED FROM THE EXACT STANDARD UNDER SECTION 523(a)(2)(A).

The Respondent argues, on page 13 of his Opposition, that the Eighth Circuit's decision in *Owens v. Miller*, 276 F.3d 424 (8th Cir. 2002), does not conflict with the Second Circuit's Summary Order since *Owens* deals with "completely different issues" than those raised in this case. However, Respondent ignores the fact that the distinction of whether a finding of fraud was combined with a finding of liability under the Securities Act, as in *Owens*, or whether combined with a fiduciary responsibility, raises the same fundamental question of whether a Bankruptcy Court can combine

two separate and fundamentally independent provisions of law to find dischargeability under Section 523(a)(2)(A). In *Owens*, the Eighth Circuit held that it could not. *Id.*, at 429 ("We see nothing in the Bankruptcy Code or the securities laws indicating that these two provisions of law should be combined in the manner the bankruptcy court did.") Thus, the Second Circuit Summary Order, which affirmed the Bankruptcy Court's finding of non-dischargeability based on the combinations of the doctrines of common law fraud and fiduciary duty, conflicts with the Eighth Circuit.

Similarly, the Second Circuit's holding is in conflict with the Fifth Circuit's decision in *Miller v. J.D. Abrams, Inc., (Matter of Miller)*, 156 F.3d 598, 602 (5th Cir., 1998), *cert. denied*, 526 U.S. 1016, 119 S. Ct. 1249, 143 L. Ed. 2d 347 (1999). In *Miller*, the Fifth Circuit did not utilize collateral estoppel even though the jury found that the appellant misappropriated trade secrets, since the jury's finding did not include a finding of fraudulent intent, an element necessary under Section 523(a)(2)(A). Thus, even though the Bankruptcy Court may have extrapolated from the jury's findings that there was an such intent, the Fifth Circuit held that, unless such explicit finding was made at the state court proceeding, the Bankruptcy Court cannot extrapolate anything from the findings of the prior proceeding except that which was explicitly found. Thus, since the jury's findings lacked the element of fraudulent intent, it cannot be used to find non-dischargeability vis-a-vis collateral estoppel. Indeed, any variance from the elements of Section 523(a)(2)(A) would preclude the prior proceeding's findings being used as a basis for non-dischargebaility.

The Respondent argues, on page 14 of his Opposition, that *Miller* should be narrowly interpreted, and "is merely an illustration of classic principles of collateral estoppel." However, the Petitioner's interpretation, that *Miller* stands for the principle that, for purposes of non-dischargeability, the prior proceeding's findings must explicitly use *only* the elements found under Section 523(a)(2)(A) is borne out in *Federal Insurance Company v. Gilson*, 250 B.R. 226 (Bnkr. E.D. VA. 2000), which interprets *Miller* as necessitating an identity of standards to apply collateral estoppel as follows:

> The Supreme Court pointed out that the elements of a state law fraud or other action may not be the same as the elements of nondischargeability. For example, under § 523(a)(4), fraud by a fiduciary is not dischargeable. But, the nature of a fiduciary under § 523(a)(4) may be different, and narrower, than under state law. *Davis v Aetna Acceptance Co.*, 293 U.S. 328, 333, 55 S. Ct. 151, 153, 79 L. Ed. 393 (1934); *Miller v. J.D. Abrams, Inc., (Matter of Miller)*, 156 F.3d 598, 602 (5th Cir., 1998), *cert. denied*, 526 U.S. 1016, 119 S. Ct. 1249, 143 L. Ed. 2d 347 (1999); 4 COLLIER ON BANKRUPTCY P 523.10[1][C], at 523-73 (15th ed. rev., 1998).
>
> For these reasons — the waste of resources by creditors, debtors and courts in forcing the litigation of all potential dischargeability issues in every pre-petition collection case for fear that the debtor might file bankruptcy in

> the indeterminate future; the expertise of the bankruptcy courts in resolving dischargeability issues; and curbing creditor abuse — the Supreme Court declined to give res judicata effect to state court judgments obtained prior to the filing of a petition in bankruptcy. n8

Federal Insurance Company, at 238.

Thus, the Second Circuit Summary Order, giving preclusive effect to the Arbitrator's Decision even though the fraud standard used by the Arbitrator is not identical to the fraud needed for Section 523(a)(2)(A), conflicts with the Fifth Circuit's holding in *Miller* that requires that the elements of fraud used in the prior proceeding cannot vary in any way from the elements under Section 523(a)(2)(A) in order to invoke collateral estoppel to find non-dischargeability. Accordingly, the Arbitrator's variance from the Section 523(a)(2)(A) standard, by utilizing the Petitioner's position as a fiduciary, bars the Arbitrator's Decision from being used as the basis for non-dischargeability vis-a-vis the doctrine of collateral estoppel.

III. CONTRARY TO THE RESPONDENT'S CONTENTION, THE SECOND CIRCUIT'S SUMMARY ORDER IS IN CONFLICT WITH ITS PRIOR HOLDING IN *BALL*

As stated in the Petition, the Second Circuit's prior decision in *Ball v. A.O. Smith Corp.*, 451 F.3d 66 (2d Cir. 2006), supports the Petitioner's argument that an identity of standards is required for "factual" collateral

estoppel under Section 523 of the Bankruptcy Code, and, thus, the decision in this case conflicts with the Second Circuit's own precedent.

The Respondent argues, on page 15 of his Opposition, that *Ball* merely stands for the notion that, in order for preclusion to apply, there has to be an identity of issues. However, in point of fact, the Second Circuit in *Ball* affirmed the lower court's application of collateral estoppel concerning non-dischargeability under Section 523(a)(6) of the Bankruptcy Code only because the Fifth Circuit had previously adopted standards under § 1927 which require findings that are the equivalent of malice. *See, Id.*, at 70. Thus, the definition of what is required under § 1927, and that which is required under Section 523(a)(6), are one and the same.

In this case, however, nowhere in the definition of fraud under Section 523(a)(2)(A) do we find a hint, even to suggest combining the elements of fraud with a fiduciary duty. Thus, the standard the Arbitrator employed in finding fraud, which factored in the Petitioner's position as a fiduciary does not fit into the definition of fraud under Section 523(a)(2)(A), and therefore could not be used as a basis for non-dischargeability through collateral estoppel.

Accordingly, the Court's intervention is necessary to resolve the conflict between the Second Circuit and Eighth and Fifth Circuits, and, indeed, to secure and maintain uniformity in the Second Circuit as well.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

JOSEPH J. HASPEL
THE LAW OFFICES OF
DAVID CARLEBACH
40 Exchange Place
New York, New York 10005
(212) 785-3041

Attorneys for Petitioner